No. 93-404

In The

Supreme Court of the United States

October Term, 1993

ARTHUR L. GUSTAFSON, DANIEL R. McLEAN and FRANCIS I. BUTLER,

Petitioners,

v.

ALLOYD CO., INC. and WIND POINT PARTNERS II, L.P.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF FOR PETITIONERS ARTHUR L. GUSTAFSON, DANIEL R. McLEAN AND FRANCIS I. BUTLER

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QUESTION PRESENTED

Whether Section 12(2) of the Securities Act of 1933 extends to a privately negotiated sale of stock.

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Petitioners, Arthur L. Gustafson, Daniel R. McLean and Francis I. Butler, respectfully submit this brief urging reversal of the judgment of the United States Court of Appeals for the Seventh Circuit, entered in this proceeding on June 11, 1993.

OPINIONS BELOW

The order of the United States Court of Appeals for the Seventh Circuit is not reported. It is included in the Joint Appendix ("JA") hereto at p. 8. The opinion of the United States District Court for the Northern District of Illinois is also not reported. It is included at JA 10.

JURISDICTIONAL STATEMENT

Invoking federal jurisdiction under 28 U.S.C. § 1331, Respondents brought suit in the United States District Court for the Northern District of Illinois under the Securities Act of 1933, as amended (the "1933 Act" or the "Act"), 48 Stat. 74, as amended, 15 U.S.C. § 77a *et seq.*, seeking civil relief under Section 12(2) of that Act, 15 U.S.C. § 77l(2) ("Section 12(2)"). On May 29, 1992, the District Court, ruling that Section 12(2) does not apply to the transaction at issue, granted Petitioners' motion for summary judgment.

On Respondents' appeal, the United States Court of Appeals for the Seventh Circuit entered a judgment on June 11, 1993, vacating the District Court's order and remanding this case to the District Court for further proceedings in light of the Seventh Circuit's opinion in *Pacific Dunlop Holdings Inc. v. Allen & Co. Inc.*, 993 F.2d 578 (CA7 1993). This Court's jurisdiction was invoked under 28 U.S.C. § 1254(1) in a Petition filed September 9, 1993. On March 7, 1994 this Court granted the Petition.

STATUTE INVOLVED

This case involves Section 12 of the 1933 Act, 15 U.S.C. § 77l, which is designated "Civil Liabilities Arising in Connection with Prospectuses and Communications" and states:

> Any person who –
>
> (1) offers or sells a security in violation of Section 77e of this title [Section 5], or
>
> (2) offers or sells a security (whether or not exempted by the provisions of 77c of this title [Section 3], other than paragraph (2) of subsection (a) of said section), by the use of any means or instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable to the person purchasing such security from him, who may sue either at law or in equity in any court of competent jurisdiction, to recover the consideration paid for such security with interest thereon, less the amount of any income received thereon, upon the tender of such security, or for damages if he no longer owns the security.

STATEMENT OF THE CASE

This case arises out of Petitioners ("Sellers") December 1989 sale of Alloyd Co., Inc. ("Alloyd") to Respondent Alloyd Co., Inc. (then named Alloyd Holdings, Inc. ("Holdings")). The sale was effectuated by Holdings' acquisition of all of Alloyd's outstanding stock pursuant to a comprehensive privately negotiated stock purchase agreement (the "Stock Purchase Agreement"). JA 87. Respondents Holdings and Wind Point Partners II, L.P. ("Wind Point") (collectively "Buyers") claim that material misrepresentations were made in the Stock Purchase Agreement and in oral communications in connection with that sale which entitle them to rescind the sale pursuant to Section 12(2). Amended Complaint at ¶¶ 34-35, JA 23.

Alloyd was a manufacturer of clear plastic blister packaging and automatic heat seal packaging equipment whose stock had been outstanding since 1961. In 1989, Sellers, who were Alloyd's sole shareholders (Gustafson 85%, McLean 10% and Butler 5%), decided to sell Alloyd. Wind Point, an experienced and sophisticated venture capital investment partnership, expressed interest in buying Alloyd. After conducting extensive due diligence regarding Alloyd, visiting Alloyd's facility and interviewing key Alloyd officers and employees, Wind Point offered to purchase Alloyd. JA 11 and 14. Sellers agreed to sell Alloyd to Holdings, a corporation formed by Wind Point to effectuate the purchase. Sellers McLean and Butler reinvested in Alloyd and became officers and directors of the new company. JA 11.

The provisions of the Stock Purchase Agreement were negotiated over several weeks. During the negotiations, Buyers conducted extensive due diligence regarding Alloyd and retained KPMG Peat Marwick ("KPMG") to conduct a formal business review of Alloyd. JA 11. As part of its review, KPMG noted that the inventory shown on Alloyd's interim financial statements was estimated and discussed with Buyers the appropriateness of taking a physical inventory. JA 11. No physical inventory was taken prior to closing. JA 11. Buyers initially sought a representation that Alloyd's financial statements presented Alloyd's financial condition "accurately and completely." Buyers ultimately agreed to a representation, which cautioned that inventory and certain accrued expenses were estimated on an interim basis and subject to adjustment at year-end, that the financial statements "present fairly" Alloyd's financial condition. JA 171, JA 115 at ¶ 4D, and JA 164.

The Stock Purchase Agreement was executed as of December 20, 1989 and the transaction closed on December 22, 1989, when Holdings purchased Sellers' stock for $18,709,000 plus a payment of $2,122,219, reflecting an estimate of Alloyd's increase in net worth from December 31, 1988 through the closing. JA 12. A provision in the Agreement required that, after the year-end audit of Alloyd's financial statements, Sellers or Buyers would remit an appropriate amount to cover any variance between the estimated increase in Alloyd's net worth and the actual increase. JA 12. After KPMG audited Alloyd's December 31, 1989 financial statements, Sellers paid

Holdings $815,000 plus interest pursuant to that provision, due in large part to an audit adjustment made to reflect Alloyd's actual inventory at year end. JA 12.

Among many other provisions, the Stock Purchase Agreement provided that Buyers would make no liability claim against Sellers unless their damage exceeded certain dollar amounts (sometimes referred to as "baskets"), JA 145 at ¶ 7B; that Buyers were sophisticated investors who would not engage in any distribution of Alloyd stock, JA 143 at ¶ 5H; that Buyers believed they had all their questions answered, JA 143 at ¶ 5H; that Buyers knew of no fact or circumstance that would make any of Sellers' representations and warranties untrue, JA 143 at ¶ 5I; and that Buyers expressly waived any rescission remedy, JA 148 at ¶ 7B(c).

On February 11, 1991, Buyers filed this case seeking rescission of their purchase of Alloyd pursuant to Section 12(2). They alleged that Alloyd's earnings were overstated in 1989 interim financial statements, claiming Alloyd's actual inventory was lower than presented in those financial statements. Buyers also alleged that oral misrepresentations were made regarding Alloyd's interim earnings. JA 23 at ¶¶ 24, 35.

The District Court's May 29, 1992 Memorandum Opinion and Order granted Sellers' motion for summary judgment as to Buyers' Section 12(2) claim, relying heavily on the reasoning in *Ballay v. Legg Mason Wood Walker*, 925 F.2d 682 (CA3), *cert. denied*, 112 U.S. 79 (1991). The District Court concluded that the privately negotiated transaction at issue in this case could not be compared to a new offering because, unlike purchasers in

most initial offerings, Buyers had direct access to financial and other information about Alloyd. JA 21.

Buyers appealed to the Seventh Circuit which, on June 11, 1993, vacated without opinion the District Court's Order and remanded the case for further consideration in light of its holding in *Pacific Dunlop*, 993 F.2d 578. JA 8.

SUMMARY OF ARGUMENT

The proper application of Section 12(2) should be determined in light of its language in the context of the 1933 Act, the structure of the Act, the evils the Act sought to cure and the overall policy of the Act. The 1933 Act was passed to prohibit solicitation of public investors based on incomplete or misleading information in prospectuses and other selling communications. The 1933 Act does so by regulating the process by which securities are offered to the public and specifying the information that must be provided before securities can be sold to the public. It provides remedies to buyers when unregistered offerings of securities are made to the public and when securities are sold to the public by means of a false or misleading registration statement, prospectus or other selling communication.

The Act was also intended, however, to interfere as little as possible with private business. By the exemptions it includes relating to transactions not involving any public offerings, the 1933 Act accomplished that purpose.

Persons selling securities by means of a misleading "prospectus or oral communication" are liable under Section 12(2) to purchasers for rescission or rescissionary damages. The Section's use of "prospectus" demonstrates it was intended to apply only in the context of sales of stock to the public, the type of transaction intended to be covered by the 1933 Act. A privately negotiated agreement to sell a company does not comport with any obvious meaning of the word "prospectus." Rather, a privately negotiated stock purchase agreement sets forth, usually after extensive due diligence by the buyer, the negotiated terms upon which a purchase of stock will take place, frequently including agreed allocation of risks relating to matters that are not certain.

The Section 12(2) cause of action and remedy is more akin to an action for breach of fiduciary duty than to an action based on fraud under Section 10(b) of the Securities and Exchange Act of 1934, as amended (the "1934 Act"), 48 Stat. 881, as amended, 15 U.S.C. § 78j(b). Such a powerful remedy for a buyer is appropriate in the context of solicitation of the public to purchase securities because the Act imposes upon those engaged in such solicitation an affirmative duty of full and fair disclosure. Such relief, however, has no proper place in a privately negotiated transaction where terms are negotiated, warranties are made, risks are allocated, and there is full access to information and both parties have bargaining power. It would be poor public policy to extend Section 12(2) to cover such negotiated transactions.

Here Sellers sold all the stock of a company to sophisticated Buyers. If Sellers breached the Stock Purchase Agreement, Buyers have a contractual remedy. If

Sellers committed fraud (which Buyers have never claimed), Buyers would have had a remedy under common law or the 1934 Act. There is no basis in the language, context or purpose of Section 12(2) for extending its fiduciary duty-based standard of liability to Buyers in this case. Petitioners respectfully request that this Court vacate the Seventh Circuit's Order and affirm the District Court's grant of summary judgment for Petitioners as to Respondents' Section 12(2) claims.

ARGUMENT

I. INTRODUCTION

A. The Competing Policies At Issue

The March 29, 1933 "Message from the President – Regulation of Security Issues" recommending the 1933 Act made clear that the legislation was aimed at requiring fair disclosure in connection with the sale of securities to the public:

> I recommend to the Congress legislation for Federal supervision of **traffic** in investment securities in interstate commerce. In spite of many State statutes the **public** in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations **selling securities**. Of course the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.

> There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information, and that no essentially important element attending the issue shall be concealed **from the buying public**.

S. Rep. No. 47, 73rd Congress, 1st Sess. (1933) (the "Senate Report"), at 1-2 (emphasis added).

The Message from the President also emphasized, however, that the aim to protect the public would be achieved with the "**least possible interference**" with honest business. Senate Report at p. 1. There is obvious tension between the goal of regulation and the concurrent goal of preservation of business freedom. How the Act reconciled these is central to the issue before this Court. As James Landis, a principal drafter of the 1933 Act, has explained (referencing discussions with Middleton Beaman, for many years the chief legislative draftsman for the House of Representatives):

> [Beaman] insisted instead on exploring the implications of the bill to find exactly what we had or did not have in mind. He probed always for the extent and nature of those hiatuses that any proposed important legislation necessarily possesses. . . . It was these discussions that first evolved the exact scope that we wanted the Securities Act to cover. "Public offerings" as distinguished from "private offerings" proved to be the answer. The sale of an issue of securities to insurance companies or to a limited group of experienced investors, was certainly not a matter of concern to the federal government.

Landis, *The Legislative History of the 1933 Securities Act*, 28 Geo. Wash. L. Rev. 29, 36-37 (1959).

The tension between these goals was reconciled by inclusion of the transaction exemptions of Section 4 of the 1933 Act (15 U.S.C. § 77d) which exempted, among other things, transactions "not involving any public offering." Referring to this exemption, this Court stated in *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124-25 (1953) (footnote omitted):

> Exemption from the registration requirements of the Securities Act is the question. The design of the statute is to protect investors by promoting full disclosure of information thought necessary to informed investment decisions. The natural way to interpret the private offering exemption is in light of the statutory purpose. Since exempt transactions are those as to which 'there is no practical need for * * * [the bill's] application,' the applicability of § 4(1) should turn on whether the particular class of persons affected need the protection of the Act. An offering to those who are shown to be able to fend for themselves is a transaction 'not involving any public offering.'

Whether a Section 12(2) remedy applies to privately negotiated transactions that Section 4 exempts from the registration requirements of Section 5 of the 1933 Act (15 U.S.C. § 77e) has never been decided by this Court and Courts of Appeal are in conflict on this issue.

In *Landreth Timber Company v. Landreth*, 471 U.S. 681 (1985), this Court dealt with an analogous issue when it determined that a private sale of all the outstanding stock of a company involved the sale of a "security" within the

meaning of the 1934 Act. Unlike the 1933 Act, however, the 1934 Act has no private offering exemption, as the Court specifically noted. *Id.* at 692. In *Landreth,* the transaction involved was preceded by comprehensive negotiations between the buyer and seller and there was no suggestion that the buyers were unable to obtain appropriate warranties or independently evaluate relevant information before entering into the transactions. Justice Stevens, dissenting, did not believe that the 1934 Act covered the private transaction, stating: "I believe that Congress wanted to protect investors who do not have access to inside information and who are not in a position to protect themselves from fraud by obtaining appropriate contractual warranties." *Id.* at 698-702 (footnotes omitted). As demonstrated below, Justice Stevens' reasoning is irrefutably applicable to this privately negotiated transaction in light of the exemption of Section 4(2) of the 1933 Act.

B. Prior Decisions By Courts Of Appeals

Prior to *Ballay* and *Pacific Dunlop,* the few Courts of Appeals addressing whether Section 12(2) applied to private transactions had reached differing conclusions.[1] In

[1] *See Cady v. Murphy,* 113 F.2d 988 (CA1), *cert. denied,* 311 U.S. 705 (1940) (upheld a Section 12(2) claim where the sale involved outstanding stock, though neither the parties nor the court directly addressed whether Section 12(2) extended to private transactions); *Woodward v. Wright,* 266 F.2d 108 (CA10 1959) (upheld a Section 12(2) claim in a secondary transaction without addressing whether 12(2) applied to private transactions); *Nor-Tex Agencies, Inc. v. Jones,* 482 F.2d 1093 (CA5 1973), *cert. denied,* 415 U.S. 977 (1974) (held that the private intrastate sale of a fractional undivided oil and gas interest was within the scope of

1991, the Third Circuit Court of Appeals in *Ballay,* addressed whether a brokerage firm's communications relating to a public market transaction were within the scope of Section 12(2). The Court analyzed the language of Section 12(2), the structure and legislative history of the 1933 Act and relevant policy considerations and concluded that Section 12(2) does not apply to secondary market transactions. The *Ballay* court found that the phrase "by means of a prospectus or oral communication" in Section 12(2) reflected Congress's intention to limit the Section's reach to initial public distributions because the term "prospectus" as used in Section 12(2) was intended to refer to a formal prospectus associated with an offering to the public. Applying the principle *noscitur a sociis* (discussed more fully below), the Court concluded that the term "oral communication" in Section 12(2) was meant to refer to oral communications made in connection with a prospectus, stating: "We believe Congress employed the term 'prospectus' as a term of art

Section 12(2) because such a transaction was not expressly exempted from the 1933 Act but did not analyze whether Section 12(2) reached such a transaction); *Haralson v. E.F. Hutton Group, Inc.,* 919 F.2d 1014 (CA5 1991) (summarily rejected a contention that Section 12(2) applied only to public offerings relying solely on *Nor-Tex Agencies*). *But see Gross v. Diversified Mortgage Investors,* 431 F. Supp. 1080 (S.D.N.Y. 1977), *aff'd mem.,* 636 F.2d 1201 (CA2 1980) (affirmed the district court's dismissal of a Section 12(2) claim based on a secondary market transaction because Section 12(2) only protects purchasers of stock sold pursuant to a misleading prospectus, which the court found is only used with respect to an initial offering). District courts too numerous to cite are in conflict on this issue, although the vast majority follow the reasoning of *Ballay* or some close variation thereof.

which describes the transmittal of information concerning the sale of a security in an initial distribution." *Id.* at 688. If Congress had intended a more expansive meaning for Section 12(2), it "more simply could have drafted Section 12 to govern all written or oral communications." *Id.* at 689. *See also First Union Discount Brokerage Services, Inc. v. Milos*, 997 F.2d 835 (CA11 1993) (following *Ballay's* reasoning and conclusion).

A 1992 article by Professor Elliot Weiss expanded and refined the *Ballay* court's argument and concluded that *Ballay* was essentially correct, but that Section 12(2) only applies to offerings "that are registered, should be registered, or are not registered solely because they involve securities that Section 3 exempts from registration." Weiss, *The Courts Have it Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 Bus. Law. 1, 4 (1992).[2] Other legal scholars have reached different conclusions.[3]

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[2] *See also*, Prentice, *Section 12(2): A Remedy for Wrongs in the Secondary Market?*, 55 Alb. L. Rev. 97 (1991). Professor Weiss argues that the first case treating this issue, *Moore v. Gorman*, 75 F. Supp. 453 (S.D.N.Y. 1948), was based on flawed research and faulty reasoning. Because Professor Loss cited the case as authority in the first edition of his influential treatise, *Securities Regulation*, this misguided view gradually gained momentum until recently. *Weiss* at 28.

[3] L. Loss, *The Assault on Securities Act Section 12(2)*, 105 Harv. L. Rev. 908 (1992); L. Loss, *Securities Act Section 12(2): A Rebuttal*, 48 Bus. Law. 47 (1992); and Maynard, *Liability Under Section 12(2) of the Securities Act of 1933 for Fraudulent Trading in Post Distribution Markets*, 32 Wm. & Mary L. Rev. 847 (1991) (claiming Section 12(2) extends to private transactions). *See also* Hirsh, *Applying Section 12(2) of the 1933 Securities Act to the Aftermarket*, 57 U. Chi. L. Rev. 955, 963 (1990).

The Seventh Circuit reached a conclusion totally contrary to *Ballay* in *Pacific Dunlop*, construing "prospectus" as defined in Section 2(10) of the 1933 Act to include all written communications in connection with sales of securities, the definition it believed was meant to apply in Section 12(2). Accordingly it held that a private sale pursuant to a stock purchase agreement was covered by Section 12(2) because the agreement itself was a "prospectus." As discussed below, the Seventh Circuit failed to recognize the limiting nature of the phrase "by means of a prospectus or oral communication" as used in Section 12(2), which shows that Section 12(2) only applies in a public offering and does not refer to a privately negotiated sale of stock. A prospectus is prepared by the person or entity making a public offering as a selling device to persuade the public to purchase securities. A stock purchase agreement is quite distinct. It is negotiated by a buyer and seller, each able to fend for itself. It is not used to solicit a transaction, but rather to reflect the terms upon which the parties agree to enter into a business transaction. A prospectus is the subject of the primary objectives of the 1933 Act. A privately negotiated agreement is not.

The Seventh Circuit also appears to have failed to recognize or properly consider the unique fiduciary nature of the liability created by Section 12(2). It appears to regard the Section as simply another "antifraud provision." *Pacific Dunlop*, 993 F.2d at 594. Plainly, as discussed below, Section 12(2) is more than that because of its fiduciary based remedy and its imposition of the burden of proof on the seller. Regarding Section 12(2) as an antifraud remedy, the Seventh Circuit erroneously relied

on legislative history concerning Section 17(a) of the Act (which is an antifraud provision) as if it were applicable to Section 12(2).

The Seventh Circuit's conclusion that Section 12(2) applies to privately negotiated transactions was erroneous. It is not warranted by the language, structure or legislative history of the 1933 Act, all of which demonstrate that Section 12(2) applies to public offerings of securities and does not extend, and was not intended to extend, to privately negotiated sales of stock.

II. THE LANGUAGE AND STRUCTURE OF THE 1933 ACT DEMONSTRATE THAT SECTION 12(2) APPLIES TO PUBLIC – NOT PRIVATE – SALES OF STOCK

A. Principles Of Statutory Construction

The starting point in every case involving statutory construction is the statutory language. *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197, *reh'g denied*, 425 U.S. 986 (1976); *Pinter v. Dahl*, 486 U.S. 622, 641 (1988). A remedial section must be read in the context of its placement in the statute and in comparison to the statute's other remedial provisions giving consideration to the object and structure of the statute as a whole. *Dole v. United Steel Workers of America*, 494 U.S. 26, 36 (1990); *Pilot Life Ins. Co. v. Dedeaux*, 481 U.S. 41, 51 (1987) ("[B]eyond the letter of the statute is the evil sought to be remedied, which is always significant in determining the meaning"); *Durland v. United States*, 161 U.S. 306, 313 (1896); *Apex Hosiery Co. v. Leader*, 310 U.S. 469, 489 (1940); *Crandon v. United States*, 494 U.S. 152, 168 (1990).

As stated in *Kern County Land Co. v. Occidental Petroleum Corp.*, 411 U.S. 582, 594-95 (1973): "[T]he courts have come to inquire whether the transaction may serve as a vehicle for the evil which Congress sought to prevent . . . thereby endeavoring to implement congressional objectives **without extending the reach of the statute beyond its intended limits**." (emphasis added).

B. "Prospectus" As Used In The 1933 Act Means A Communication Soliciting The Public To Purchase Securities

Section 12(2) of the 1933 Act provides that every person who sells securities "by means of a prospectus or oral communication" that contains a materially false or misleading statement shall be liable to the person who purchased those securities for rescission or rescissionary damages. The question before this Court is whether Congress intended to subject sellers of securities in privately negotiated transactions to this stringent liability provision. To answer that question, this Court must decide the meaning of the phrase "by means of a prospectus or oral communication" as used in Section 12(2).

Plain English and established principles of statutory construction show that the phrase "by means of a prospectus or oral communication" limits the scope of Section 12(2) to sales made by means of documents that solicit investments from public investors and oral communications that relate to such documents. The word "prospectus" has, and in 1933, had, this well-established meaning. Black, *A Law Dictionary* 959 (2d ed. 1910) defined "prospectus" as:

A document published by a company or corporation, or by persons acting as its agents or assignees, setting forth the nature and objects of an issue of shares, debentures or other securities created by the company or corporation, *and inviting the public to subscribe to the issue.*

(emphasis added).

That Congress intended the word "prospectus" in Section 12(2) to be read in this generally accepted sense is evident from the purpose and legislative history of the 1933 Act. As stated in *Ernst & Ernst v. Hochfelder*, 425 U.S. at 195, the 1933 Act "was designed to provide investors with full disclosure of material information concerning public offerings of securities in commerce. . . . " *See also Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 752, *reh'g denied*, 423 U.S. 884 (1975) (The 1933 Act is "chiefly concerned with disclosure and fraud in connection with offerings of securities – primarily, as here, initial distributions of newly issued stock from corporate issuers."); *United States v. Naftalin*, 441 U.S. 768, 777-78 (1979) (the 1933 Act was "primarily concerned with the regulation of new offerings").

The House Report regarding H.R. 5480, H. Rep. No. 85, 73d Cong., 1st Sess. (1933) (the "House Report") made it clear that a prospectus was a selling document (and that the private remedies under Sections 11 and 12 were to afford relief to those who purchased securities as part of a public distribution) stating:

The committee emphasizes that these liabilities attach only when there has been an untrue statement of material fact or an omission to state a material fact in the registration statement or the

prospectus – the basic information by which the public is solicited.

House Report at 9 (emphasis added).

As shown more fully below, Congress made it abundantly clear that, with the singular exception of Section 17(a), 15 U.S.C. 77q(a), the 1933 Act was directed at regulating public offerings of securities. The 73rd Congress was equally clear that private transactions between sophisticated parties – such as the transaction involved in the instant case – are beyond the scope of the 1933 Act.

Section 2(10) of the 1933 Act defines various terms used in the Act stating:

"[U]nless the context otherwise requires[4] . . . The term "prospectus" means any prospectus, notice, circular, advertisement, letter or communication, written or by radio or television, which offers a security for sale or confirms the sale of the security . . . "

15 U.S.C. § 77b(10).[5] It is well-established that words grouped in a list should be given related meaning. As

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[4] Referring to this "context" phrase, this Court has noted that "Congress itself has cautioned that the same words may take on a different coloration in different sections of the securities laws." *SEC v. National Securities, Inc.*, 393 U.S. 453, 466 (1969).

[5] The words "confirms the sale of any security" do not broadly expand the definition of "prospectus." Congress was using the word "confirm" not generally but as a term of art to refer to brokers' confirmations only. This Court has repeatedly held that literal interpretation should not overcome common sense or plain statutory purpose. In *Marine Bank v. Weaver*, 455 U.S. 551, 558-59 (1982), this Court, relying upon the "context clause" in the 1934 Act which is identical to that in the 1933 Act,

explained in *Jarecki v. G.D.Searle & Co.*, 367 U.S. 303, 307 (1961): "[T]he maxim *noscitur a sociis*, that a word is known by the company it keeps, while not an inescapable rule, is often applied where a word is capable of many meanings **in order to avoid giving unintended breadth to Acts of Congress**." (emphasis added). The list of communications set forth in Section 2(10) should be read in this fashion, and can easily be so read. That is, Congress drafted the definition so that the only written (or broadcast) communications that qualify as a "prospectus" are the circular(s), advertisement(s), letter(s) or other communication(s) that, like a "prospectus," solicit the

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see 15 U.S.C. § 78c, held that a bank's certificate of deposit was not a "security" under the 1934 Act even though the certificate fit within the literal definition of a security because it was unnecessary to subject the issuers of such certificates, the holders of which were abundantly protected by the federal banking laws, to liability under the antifraud provisions of the federal securities laws. In *Reves v. Ernst & Young*, 494 U.S. 56, 63 (1990), this Court determined that not every note was a "security" for purposes of the 1934 Act even though the 1934 Act's definition of security included the phrase "any note" because the phrase "must be understood against the backdrop of what Congress was attempting to accomplish in enacting the Securities Acts." *See also Byrnes v. Faulkner, Dawkins & Sullivan*, 550 F.2d 1303, 1310 (CA2 1977) ("Section 2(10) [of the 1933 Act] need not literally apply if reason indicates otherwise."). As the Seventh Circuit observed in *Sutter v. Groen*, 687 F.2d 197, 200 (CA7 1982), the *Marine Bank* Court treated "the word context in the introductory clause of Section 3(a)(10) [of the 1934 Act] as having reference to the economic as well as linguistic context." *See* H. Rep. No. 1542, 83d Cong., 2d Sess. (1954).

public to purchase securities.[6] Communications – and particularly privately negotiated agreements – that do not serve that function are not included.

So reading Section 2(10) makes sense of Section 12(2) which, by including the phrase "by means of a prospectus or oral communication" defines the scope of the Section's application – to public offerings. Congress could have expanded the scope of Section 12(2) by simply stating it applied to sales by means of "any communication." It did not. This Court has observed that a statute should be read so as "to give effect, if possible, to every clause and word . . . " *United States v. Menasche*, 348 U.S. 528, 538-39 (1955) (quoting *Montclair v. Ramsdell*, 107 U.S. 147, 152 (1882)). *See also Reves v. Ernst & Young*, 494 U.S. 56, 63 (1990) (rejecting a proffered interpretation of the word "conduct" in RICO that would have rendered that word superfluous). *Compare* Uniform Securities Act § 410(a)(2), 7B U.L.A. 643 (1985), which is intended to apply to all sales of securities, and which tracks Section 12(2) in all material respects except that it contains no reference to "by means of a prospectus or oral communication." If the

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[6] As stated by Sen. Fletcher: "People have been persuaded to invest their money in securities without any information respecting them, except the advertisements put forth by the agents or representatives of those issuing the securities, and such advertisements have not given full information **to the public**." 77 Cong. Rec. 2982 (1933) (emphasis added). Rep. Bulwinkle stated: "[N]early everyone has read those lurid advertisements issued by American concerns advising the **American public** to purchase these securities." *Id.* at 2924 (emphasis added).

phrase "by means of a prospectus or oral communication" is to be given any effect, one must read Section 12(2) as applicable to some, but not all, sales of securities. The intended effect, given the language use and the purpose of the 1933 Act, was to limit Section 12(2) to public sales of stock.

Buyers, relying on *Pacific Dunlop*, maintain that the Section 2(10) definition of the term "prospectus" means any written communication that offers a security for sale or confirms the sale of a security. This, coupled with the inclusion of "or oral communication" in Section 12(2), means – Buyers assert – that Section 12(2) applies to **every** sale of a security, since every such sale involves some oral or written communication.

In Section 12(2), Congress used the term "prospectus" in its usual and customary sense, as a reference to a document that solicits public investors to purchase securities.[7] The Stock Purchase Agreement is simply not a prospectus. *See Marine Bank v. Weaver*, 455 U.S. at 551, 560 (1982), determining that a privately negotiated agreement

[7] As the House Report states at 8:

> Any objection that the compulsory incorporation **in selling literature and sales argument** [solicitation] of substantially all information concerning the issue, will frighten the buyer with the intricacy of the transaction, states one of the best arguments for the provision. The **rank and file of securities buyers** who have hitherto bought blindly should be made aware that securities are intricate merchandise.

(emphasis added). Sophisticated purchasers in negotiated private transactions are certainly not such "rank and file" and do not require the described protection.

among businessmen to share profits was not a security, noting that the sellers distributed no "prospectus" plainly implying that the agreement itself was not a prospectus.

The 1933 Act as a whole establishes an intricate and comprehensive regulation of the method of disseminating as well as the substance of, information as offerings are made to the public.[8] Pursuant to Section 5 of the 1933 Act, a person may not, absent an appropriate exemption, offer or sell a security to the public without filing a registration statement. *See A.C. Frost & Co. v. Coeur D'Alene Mines Corp.*, 312 U.S. 38, 43 (1941). As this Court observed in *Pinter v. Dahl*, 486 U.S. at 638:

> The registration requirements are the heart of the Act, and § 12(1) imposes strict liability for violating those requirements. Liability under § 12(1) is a particularly important enforcement tool, because in many instances a private suit is the only effective means of detecting and deterring a seller's wrongful failure to register securities before offering them for sale.

[8] As stated by Rep. Mapes:

> The object of the legislation, in brief, is to require those who issue securities **to be sold to the public** through the mails or by the use of the instruments of interstate commerce to furnish material information **to the public about the securities which they are asking the public to buy**. That, in my judgment, will be the chief and primary accomplishment of the legislation. **It will make available to the public the information upon which the public is asked to invest its money.**

77 Cong. Rec. 2912 (1933) (emphasis added).

The registration and prospectus dissemination requirements of the 1933 Act focus exclusively on public offerings and have no applicability to privately negotiated transactions. While space here does not permit a detailed description of how the Act requires and regulates dissemination of information in a public offering, that description is set forth in detail in *Weiss, supra* at 9-12. Plainly a privately negotiated stock purchase agreement plays no intended role in that statutory scheme.

In sum, the 73rd Congress was seeking to regulate numerous prospectuses, advertisements and other communications directed toward the public which had been the cause of the public being misled. Congress was not concerned, and did not want to interfere, with the thousands of privately negotiated transactions involving sophisticated parties able to fend for themselves. The 1933 Act's overall structure demonstrates most convincingly that the phrase "prospectus" in Section 12(2) connotes selling literature in connection with an offering of securities to the public – and not "any communication" in a privately negotiated transaction.

This Court should reject Buyers' assertion that "prospectus" in Section 12(2) means "any written communication" which makes the word superfluous because doing so will be "extending the reach of the statute beyond its intended limits." *Kern County Land Co.* 411 U.S. 582.

C. The Type Of Remedy Afforded By Section 12(2) Connotes Application To Public – Not Private – Sales of Stock

The private remedies in the 1933 Act are designed to compel compliance with the Act's mandatory disclosure requirements relating to offerings of securities to the public. As stated in *Randall v. Loftsgaarden*, 478 U.S. 647, 659 (1986), "Congress chose a rescissory remedy when it enacted § 12(2) in order to deter prospectus fraud and encourage full disclosure. . . . " Section 12(2) represents a drastic and fundamental change in the common law but only as to transactions involving solicitation of "other people's money" in public offerings of stock through prospectuses and similar types of selling communications. Under Section 12(2), a plaintiff need not show scienter, reliance or causation. The standard for liability is negligence, and the statute imposes upon a seller the burden of proof in establishing his freedom from such negligence.

The House Report, at 5, states as follows regarding the civil liabilities imposed by the Act: "Their essential characteristic consists of a requirement that all those responsible for statements upon the face of which the **public is solicited** to invest its money shall be held to standards **like those imposed by law upon a fiduciary**" (emphasis added). The Report later explained that, where selling statements are made to the public, the persons making the statements are liable not only if they cannot prove they did not know of "the flaw in the information **offered to the public**," but also if they cannot prove that they could not have found the flaw and that they believed the information provided was true. Explaining

this burden of proof, the Report stated: "Unless responsibility is to involve merely paper liability it is necessary to throw the burden of disproving responsibility for reprehensible acts of omission or commission on those who purport to issue statements **for the public's reliance.**" *Id.* at 9 (emphasis added). As stated by Sen. Fletcher, "All **publicity** which induces the public to invest should carry with it an obligation of personal liability for the facts stated." 77 Cong. Rec. 3233 (1933) (emphasis added).

The House Report acknowledges that, under Section 12(2), a purchaser may recover based upon a misrepresentation in a prospectus which the buyer may never have seen. *Id.* at 10. The justification given by the Report for allowing this extraordinary remedy presupposes that an action brought under Section 12(2) will arise in the context of a public distribution:

> The statements for which [persons] are responsible, although [the statements] may never actually have been seen by the prospective purchaser, **because of their wide dissemination**, determine the market price of the security, which in the last analysis reflects those manifold causes that are the impelling motive of the particular purchase. The connection between the statements made and the purchase of the security is clear, and, for this reason, it is the essence of fairness to insist upon the assumption of responsibility for the making of these statements.

Id. (emphasis added). Plainly as to private sales of stock, where there is no such "wide dissemination" and no "market price," Congress did not contemplate liability under Section 12(2).

A seller of securities in an offering to the public should bear liability for rescission or rescissionary damages because the seller receives the full purchase price from the buyer and is generally the buyer's sole source of information concerning the value, risk, and quality of the security. The fiduciary duty based remedy of Section 12(2) is consistent with the congressional purpose of regulating and promoting full disclosure in public distributions and penalizing those failing to comply by forcing disgorgement of the entire amount the seller received irrespective of the damages actually suffered by the buyer.

That Section 12(2) applies only to solicitations of the public is also evidenced by the fact that it only protects a buyer. In the context of public offerings, a remedy solely for buyers makes complete sense because buyers injured by misinformation in selling communications require a statutory remedy since they have no contractual protection. In contrast, in a privately negotiated transaction, a buyer has the ability to demand access to information and negotiate the terms of the purchase. In such transactions, a fiduciary duty based standard of liability and related rescission remedy imposed only on buyers simply makes no sense. Fraud or breach of contract remedies should be available to each party to such a transaction to compensate for any actual loss sustained. *See* Sections 10(b) and 18(a) of the 1934 Act and Rule 10b-5, 17 C.F.R. § 240.10b-5 (1992).

Unlike a purchaser in the context of a public offering, a private buyer has a direct agreement with the seller, oral or written, upon which the buyer can base his claims. Neither the 1933 Act nor its legislative history purports to

justify imposition of the strict Section 12(2) standard of liability in privately negotiated transactions. If Congress intended to change so drastically the fundamental relationship between sellers and buyers in private transactions it undoubtedly would have said so. That Congress did not shows that it never contemplated, much less intended, that Section 12(2) would apply to privately negotiated sales.[9]

D. Comparison Of The Section 12(2) Remedy To Other Remedies Shows It Applies To Public – Not Private – Sales Of Stock

As stated in *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 (1976) (quoting *SEC v. National Securities, Inc.*, 393 U.S. 453, 466 (1969)), "interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen. . . . " To interpret "prospectus" as limited to documents that solicit the public to purchase securities is entirely consistent with the Act's liability scheme.

The Act contains two civil liability sections, Sections 11 and 12. Section 11, 15 U.S.C. § 77k, imposes "the high standards of trusteeship" on those with greatest responsibility for public offerings and thereby promotes the integrity of the information included in registration statements. If a registration statement contains a false or

[9] As explained in *Chisom v. Roemer*, 501 U.S. 380, n. 23 (1991) and *Church of Scientology v. I.R.S.*, 484 U.S. 9, 17-18 (1987), absence of supporting legislative history in this context is analogous to the "dog that did not bark" referenced in Arthur Conan Doyle, *Silver Blaze*, Complete Sherlock Holmes 335 (1927).

misleading statement of material fact, the issuer is strictly liable under Section 11 for losses incurred by those who purchased the securities the statement covers. Others with responsibility for the offering – including the officers who signed the registration statement, the issuer's directors, and those who underwrote the offering – are also liable unless they establish that they exercised due diligence, including making a reasonable investigation, to ensure that the registration statement contained no material misrepresentations. *See Ernst & Ernst v. Hochfelder*, 425 U.S. at 208-210.

Section 12(1) is the Act's most basic liability provision. It ensures compliance with the Act's registration and information dissemination requirements by making any person who offers or sells a security in violation of Section 5 strictly liable for rescission. Section 12(2) rounds out the Act's liability provisions by imposing liability on persons who make misrepresentations by means of a prospectus or related oral communications. Given its position as a subsection in Section 12, and particularly its use of "prospectus," Section 12(2) cannot reasonably be construed as applicable to private transactions while the closely related Section 12(1) plainly applies only to public offerings. Without Section 12(2), significant gaps would exist in the statutory scheme, and purchasers victimized by sellers' misrepresentations in a number of settings, all involving public offerings, might otherwise have no remedy. *See Byrnes v. Faulkner, Dawkins & Sullivan*, 413 F. Supp. 453 (S.D.N.Y. 1976), *aff'd*, 550 F.2d 1303 (CA2 1977) (discussing the relationship and separate functions of Sections 12(1) and 12(2) assuming both related to public distributions of securities).

First, Section 12(2) creates a remedy against a seller who has used materially false or misleading statements to sell securities in unregistered public offerings when a Section 12(1) claim might be barred by the applicable statute of limitations.[10] Section 12(2) also supplements Section 11 by adding a remedy against dealers with respect to statutory prospectuses and against all persons who sell securities in registered public offerings by means of materially false or misleading oral statements not prohibited by Section 5.[11] Moreover, Section 12(2) creates a remedy against all sellers, including issuers, underwriters and dealers, who make materially false or misleading statements in connection with a public offering of securities (other than securities exempted by Section 3(a)(2), 15 U.S.C. § 77c(a)(2)) that are exempted from registration by Section 3. This allows purchasers to recover when sellers misrepresent material facts in connection with public offerings effectuated, for example,

[10] A buyer in such an offering must bring a Section 12(1) claim within one year of the violation. Section 13, 15 U.S.C. § 77m. Section 12(2), in combination with Section 13, however, allows a purchaser a longer period to discover he has been defrauded before his action will be time-barred. Purchasers have had occasion to rely on Section 12(2) for protection in just such situations. *See MacClain v. Bules*, 275 F.2d 431, 437 (CA8 1960); *Stone v. Fossill Oil & Gas*, 657 F. Supp. 1449, 1457-58 (D.N.M. 1987); *Woods v. Home & Structures, Inc.*, 489 F. Supp. 1270, 1289 (D. Kan. 1980); *Felts v. National Accounts Sys. Ass'n, Inc.*, 469 F. Supp. 54, 64 (N.D. Miss. 1979).

[11] Section 11 creates no liability for dealers, see William O. Douglas & George E. Bates, *The Federal Securities Act of 1933*, 43 Yale L.J. 171, 208 (1933), and creates liability for issuers, underwriters and others responsible for registered offerings only with respect to misrepresentations in the registration statement.

pursuant to Regulation A, Regulation B or the intrastate offering exemption.[12] In sum, the role of Section 12(2) in the scheme of the 1933 Act was to complement Section 12(1) in imposing liability as to all types of solicitations of the public to purchase securities.

That Section 12(2) was not intended to apply to privately negotiated sales is also demonstrated by a comparison with the language of Section 17 of the 1933 Act which makes it unlawful "directly or indirectly" to obtain money or property by means of any untrue statement in the sale of a security. 15 U.S.C. § 77q. This language differs greatly from the phrase "offers or sells . . . by means of a prospectus or oral communication" used in Section 12(2). In *United States v. Naftalin*, 441 U.S. at 778, this Court observed that Section 17 was "[u]nlike much of the rest of the [1933] Act," in that it was intended to cover any scheme to defraud "whether in the course of an initial distribution or in the course of ordinary market trading." The Court's conclusion relied heavily upon statements made in the Senate and House Reports which, unlike the legislative history of Section 12(2), explicitly demonstrated an intention to apply Section 17 to transactions in both the primary and secondary securities market.

[12] *See Globus v. Law Research Serv., Inc.*, 287 F. Supp. 188 (S.D.N.Y. 1968), *aff'd in part and rev'd in part*, 418 F.2d 1276 (CA2 1969), *cert. denied* 397 U.S. 913 (1970); *Dale v. Rosenfeld*, 229 F.2d 855 (CA2 1956); *Pawgan v. Silsenstein*, 265 F. Supp. 898 (S.D.N.Y. 1967).

Finally, that the 1934 Act created broad fraud remedies for buyers (as well as sellers) in connection with private (as well as public) sales of stock, is perhaps the strongest affirmation that Congress did not believe Section 12(2) – a better remedy for buyers than the fraud remedy in the 1934 Act – applied to private sales of stock.

The limiting words "by means of a prospectus or oral communication" in Section 12(2), particularly in comparison to the significantly broader language of Section 17, shows clearly that the former had more limited scope than the latter. Had the 73rd Congress wished Section 12(2) to be coextensive with Section 17 in reaching all transactions, it would have simply stated that any misrepresentations "by means of any communication" in connection with the sale of a security would give rise to a Section 12(2) claim. Or, as it did in Section 17, it could have said "any person who offers or sells a security . . . by means of a misleading statement" shall be liable. The compelling inference is that Congress did not do so because Section 12(2) was not intended to be applicable to sales outside the public offering context.

III. THE PURPOSE OF THE 1933 ACT AND RELEVANT LEGISLATIVE HISTORY DEMONSTRATE THAT SECTION 12(2) APPLIES TO PUBLIC – NOT PRIVATE – SALES OF STOCK

A. The 1933 Act Was Intended To Require Full Dissemination Of Essential Information By Persons Soliciting The Public To Buy Securities

As explained in *Landis, supra,* at 36, the "patent concern" of the Act's draftsmen was "the flow of securities

from the issuer through underwriters **to the public** rather than with the subsequent buying and selling of these securities by the public"; *see also* L. Loss, *Fundamentals of Securities Regulation* at 92 (1983) ("The primary purpose of the 1933 Act was the regulation of the **distribution** of securities. Post-distribution trading is regulated by the 1934 Act.") (emphasis added). As stated in Abrams, *The Scope of Liability Under Section 12 of the Securities Act of 1933: "Participation" and The Permanent Legislative Materials,* 15 Fordham Urb. L.J. 877, 906 (1987), "Lawmakers in 1933 knew that the securities bill primarily regulating **distribution** would be followed swiftly by one primarily regulating trading. . . ." (emphasis added).

The bills that ultimately became the 1933 Act were S. Bill 875 and H.R. 5480. The evils toward which S. Bill 875 was directed were succinctly stated in the Senate Report accompanying that Bill:

> The purpose of this bill is to **protect the investing public and honest business**. The basic policy is that of informing the investor of the facts concerning securities to be offered for sale in interstate and foreign commerce and providing protection against fraud and misrepresentation.
>
> The aim is to prevent further exploitation **of the public** by the sale of unsound, fraudulent, and worthless securities through misrepresentation; to place adequate and true information before the investor; to protect honest enterprise, seeking capital by honest presentation, against the competition afforded by dishonest securities **offered to the public** through crooked promotion; to restore the confidence of the prospective investor in his ability to select sound securities;

> to bring into productive channels of industry and development capital which has grown timid to the point of hoarding; and to aid in providing employment and restoring buying and consuming power.
>
> It is the conviction of the committee that these aims may be largely achieved upon the basis of fidelity to truth. Confidence must and may be restored upon the enduring basis of **honesty with the public**.
>
> The necessity for the bill arises out of the fact that billions of dollars have been invested in practically worthless securities, both foreign and domestic, including those of foreign governments, **by the American public** through incomplete, careless or false representations. The result is a dire national distress. In the protection **of the public** in its purchase of securities, the United States lags far behind other nations.

Senate Report at 1-2. As stated by Sen. Fletcher:

> Acting under [the commerce clause and the postal provisions] of the Constitution, we have undertaken to impose certain restrictions and to provide certain regulations in reference to securities **that are being offered to the public** throughout the country from time to time.
>
> We have no federal legislation covering this situation, and so, **in order to protect the public and in order to protect investors, this bill has been devised**.

77 Cong. Rec. 2983 (1933) (emphasis added). *See also* House Report at 2-3.[13]

In its General Analysis of the Bill, the House Report stated:

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[13] In addressing the legislative history, the Court in *Pacific Dunlop*, placed importance on the absence in the Senate Report of any statement similar to that in the House Report indicating that the "sale" referred to initial offerings:

> Although the legislative history in the House report can be read to focus solely on those offerings pursuant to a registration statement and prospectus (or in the Third Circuit's words, to initial offerings), the Senate's version of the 1933 Act and the conference report do not confirm the House's comments.

Pacific Dunlop, 993 F.2d at 592. This misses or ignores the fact that S. Bill 875 had an isolated transaction exemption (in essence exempting private transactions) which made clear the Senate's fundamental agreement with the House that the Act would be directed only toward abuses in the context of distributions of securities to the public. Plainly, the Senate Bill did not conflict with the House's comments. In any event, as acknowledged by the Seventh Circuit, "[t]he Senate rarely mentioned the word 'prospectus' and certainly not in the fraud (sic) context of Section 12(2). And the Senate, as compared to the House, did not draft as detailed a report in support of the bill." *Id.* at 591. Nonetheless, the court relied on silence by the Senate to negate the House Report statement that Section 11 and 12 liabilities attach only to untrue statements "in the registration statement or the prospectus – **the basic information by which the public is solicited**." House Report at 9. The Conference Committee Report, H.R. Rep. No. 152, 73d Cong., 1st Sess. (1933) (the "Conference Committee Report"), indicates that the Committee did not view Section 12(2) as applicable to a private resale, observing only that "A point of difference between the House bill and the Senate amendment concerned the civil liability of persons responsible for the **flotation of an issue**" which signals agreement of the House and Senate that liability was limited to such a context. Conference Report at 26-27.

> The bill affects only new **offerings** sold through the use of the mails or of instrumentalities of interstate or foreign transportation or communication. It does not affect the ordinary redistribution of securities **unless such redistribution takes on the characteristics of a new offering** by reason of the control of the issuer possessed by those responsible for the **offering**.

House Report at 5 (emphasis added).[14]

The foregoing demonstrates conclusively that in adopting the 1933 Act the 73rd Congress intended that the Act apply to offerings of securities to the public, not privately negotiated transactions.

B. The 1933 Act Was Intended To Intrude No Further Than Necessary Into Business Affairs

Implementing the intent of Congress to interfere as little as possible with private business, S. Bill 875 and H.R. 5480 both included provisions exempting transactions not having the essential characteristics of a public offering. Section 12(c) of S. Bill 875 exempted from the bill:

> Isolated transactions in which any security issued subsequent to the date of approval of this Act is sold, or offered for sale, subscription, or delivery by the owner thereof, or by his representative solely for the owner's account, such sale or offer for sale, subscription, or delivery not being made in the course of repeated and successive transactions of a like character by such owner for the purpose of engaging in the purchase and sale of securities as a business, such owner or representative not being the issuer or underwriter of, or selling agent for, such security.

[14] Under the 1933 Act, the term "distribution" is generally treated as synonymous with the term "public offering." Section 2(11) of the Act assumes this to be the case. 15 U.S.C. § 77b(11). *See also Gilligan, Will & Co. v. S.E.C.*, 267 F.2d 461, 466 (CA2 1959), *cert. denied*, 361 U.S. 896 (1959); *Cheltenham Bank v. Drexel Burnham Lambert, Inc.*, 1989 Fed. Sec. L. Rep. ¶ 94,391 (E.D.N.C. 1989); *Neuwirth Investment Fund, Ltd. v. Swanton*, 422 F. Supp. 1187 (S.D.N.Y. 1975).

The exemption of transactions "not involving any public offering" by Section 4 of H. R. 5480 (and ultimately incorporated in the 1933 Act) demonstrates even more clearly that the disclosure and private remedy provisions of the 1933 Act were limited to public offerings. Discussing this exemption, the House Report stated: "In view of these exemptions and the restriction of the bill's application to new offerings, **the bill does not affect transactions beyond the need of public protection** in order to prevent recurrences of demonstrated abuses." *Id.* at 7 (emphasis added).

In discussing when stockholders might become underwriters, thus losing the Section 4 exemption, the House Report stated:

> At some future date [the stockholders] may wish to dispose of their holdings and to **make an offer of this stock to the public**. Such a public offering may possess all of the dangers attendant upon a new offering of securities. Whenever such a redistribution reaches significant proportions, the distributor would be in the position of controlling the issuer and thus able to furnish the information demanded by the bill.

> This being so, the distributor is treated as equivalent to the original issuer and, **if he seeks to dispose of the issue through a public offering he becomes subject to the Act.**

Id. at 13-14 (emphasis added).

In sum, the exemptions in the respective bills, and the Reports and other relevant legislative history, repeatedly demonstrate the 73rd Congress' judgment that there was not sufficient public benefit to require **all** sellers of stock to comply with the stringent duties imposed on sellers engaging in public offerings. Rather, they confirm Congress' fulfillment of its commitment to limit the 1933 Act to regulating offerings of securities to the public while interfering as little as possible with private business transactions like that at issue in this case.

IV. IT WOULD BE POOR PUBLIC POLICY TO APPLY THE SECTION 12(2) REMEDY TO PRIVATE SALES OF STOCK

This Court has acknowledged that, in construing terms in the federal securities acts, it is proper to consider the policy considerations involved. *See Pinter*, 486 U.S. at 653; *Landreth*, 471 U.S. at 694-95 n.7 (1985). In particular, policy considerations can be considered when they help to show that adherence to text or structure would lead to a result so "bizarre" that Congress could not have intended it. *Demarest v. Manspeaker*, 498 U.S. at 191 (1991). Those policy considerations all militate against extension of Section 12(2)'s remedy to privately negotiated transactions.

The extension of Section 12(2) and its stricter standards of liability to private transactions currently governed by Section 10(b) of the 1934 Act would afford all buyers, and only buyers, a remedy which effectively renders superfluous Rule 10b-5 and years of precedent with respect to scienter, reliance, and loss causation under that Rule. *See Ernst & Ernst v. Hochfelder*, 425 U.S. 306; *Sharp v. Coopers & Lybrand*, 649 F.2d 175 (CA3 1981), *cert. denied*, 455 U.S. 938 (1982); *Basic v. Levinson*, 485 U.S. 224 (1988); *Central Bank of Denver v. First Interstate Bank of Denver*, No. 92-485, 1994 WL 132212 (U.S. April 19, 1994).

In privately negotiated transactions, contract remedies and the stricter standards of proof governing a Rule 10b-5 action, equally available to sellers and buyers, are far more appropriate than the standards governing a Section 12(2) action. There is no imbalance in the availability of information as between sellers and buyers and each of them is able to fend for itself, negotiate its rights and avail itself of the remedies afforded under the law of its contracts as supplemented by Rule 10b-5.

A broad construction of the scope of Section 12(2) here would have a drastic impact on the thousands of private transactions negotiated and closed yearly. This simply cannot be squared with the declarations, discussed above, of the President and the 73rd Congress to intrude as little as possible in business affairs. At a minimum, such a broad application of Section 12(2) would dramatically and unnecessarily increase transaction costs by forcing unnecessary due diligence onto sellers and their professionals to avoid unintentional misrepresentation. It would appear that the only way that a seller could assure itself of avoiding a possible "omission" within the

meaning of Section 12(2) would be to disclose all the information required in a registration statement to a buyer, even where a sophisticated buyer is expressly willing to assume a risk relating to a decision not to conduct an investigation. *See generally* Weiss, *supra*, at 32. ("Sophisticated parties negotiating at arm's length should be allowed to agree to so allocate the burden of investigation. If the law requires a seller to bear that burden even though the parties prefer to assign it differently, transaction costs will increase unnecessarily."); Fishman, *Duty to Disclose under Rule 10b-5 in Face-to-Face Transactions*, 12 J. Corp. L. 251 (1987) ("[O]ne of the underlying themes in these types of transactions is that the parties are in a position to obtain the protections and disclosure that they desire – that is, representations and warranties are obtained by a purchaser concerning only the matters in which it is interested"). Only if clearly mandated by the 1933 Act should it be applied to interfere so directly with the parties' freedom to reach such agreements – in a private setting – as they deem appropriate.

As in this case, interim financial statements nearly always include estimated components. While sellers may well be willing to represent the accuracy of the estimates if their exposure is limited to a buyer's damage in the event the estimate is erroneous, Section 12(2) applicability would nearly always force them to conduct an audit rather than risk giving the buyer an option to rescind the transaction. Further, because the provisions of the securities laws cannot be waived, 15 U.S.C. § 77o, such a construction would appear to render unenforceable the "baskets" which are frequently included in stock

purchase agreements quantifying the level of damages necessary to create a right to relief under the negotiated agreement.

Moreover, the broad construction Buyers seek would turn cases which are properly state breach of contract cases (based on the representations in the contract) into federal cases which shift the burden of proof onto the defendant, impose a negligence standard of liability and allow the unique rescission remedy. This also will obviously increase the already overburdened federal court system.

Finally, the powerful and positive remedy of Section 12(2) applied so expansively would certainly provide an irresistible temptation to any buyer who is disappointed for any reason with its purchase to attempt to concoct a claimed misrepresentation given the burden of proof that Section 12(2) imposes on a seller.

Extending the remedy of Section 12(2) to privately negotiated transactions would interfere totally and unnecessarily with the ability of private parties to set the limits of their bargains and undertakings and dramatically increase the cost of such transactions and increase litigation, often frivolous federal court litigation. Petitioners respectfully submit that the Court should not apply Section 12(2) so broadly given the negative impact on the public interest of such an expanded application.

CONCLUSION

The language of Section 12(2), the purpose and structure of the 1933 Act, the legislative history of the Act and Section 12(2) and the interplay between the 1933 Act and the 1934 Act all demonstrate that Section 12(2) was not intended to apply to privately negotiated sales of stock.

The District Court correctly concluded that Section 12(2) does not apply to this privately negotiated sale of the stock of Alloyd to Buyers and its summary judgment in Sellers' favor should be reinstated and affirmed.

Respectfully submitted,

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No. 93-404

In The

Supreme Court of the United States

October Term, 1993

ARTHUR L. GUSTAFSON, DANIEL R. McLEAN and FRANCIS I. BUTLER,

Petitioners,

v.

ALLOYD CO., INC. and WIND POINT PARTNERS II, L.P.,

Respondents.

On Writ Of Certiorari To The United States Court Of Appeals For The Seventh Circuit

BRIEF OF RESPONDENTS

STATEMENT OF THE CASE

This case involves the sale of substantially all of the stock of Alloyd Co., Inc. by the three shareholders who owned and controlled the company. They solicited buyers, and ultimately sold their stock to an affiliate of respondent Wind Point Partners, II, L.P. ("Wind Point"). The sellers of Alloyd's stock, who are the petitioners in this case, made numerous written and oral representations about Alloyd to induce Wind Point's purchase of their shares. Respondents eventually discovered that some of these representations were untrue and sued for rescission under section 12(2) of the Securities Act of 1933, 15 U.S.C. § 77l(2).

The Transaction At Issue

Alloyd Co., Inc. was founded in 1961 by petitioner Arthur Gustafson. (R. 56, Dep. Ex. 2 at 1)[1] Prior to the transaction at issue in this case, all of Alloyd's stock was owned by Gustafson and the other two petitioners – Daniel McLean and Francis Butler. Gustafson (Alloyd's president) owned 85 percent, McLean (chief financial and operating officer) owned 10 percent, and Butler (vice president for marketing and sales) owned 5 percent.[2] (R. 56, Dep. Ex. 5 at 19) There is no evidence in the record that shares of Alloyd's stock were ever sold or distributed to any person before the sale to Wind Point.

In May 1989, Gustafson, McLean and Butler decided to sell their Alloyd stock. (R. 56, Dep. Ex. 3 at 1) A proposal was made to the Alloyd board that "the Company actively solicit bids for the purchase of all of the outstanding stock of the Company." (*Id.*) In a Written Consent Of Directors dated May 5, 1989, Alloyd's directors authorized Gustafson "to engage KPMG Peat Marwick on behalf of the Company and its shareholders in the solicitation and evaluation of offers to purchase the Company." (*Id.*)

Peat Marwick prepared a detailed "Profile" of Alloyd to use as a selling tool with prospective buyers. (R. 56, Dep. Exs. 2 and 5; McLean Dep. 132) The Profile described Alloyd's operating, financial, marketing and other characteristics. (R. 56, Dep. Ex. 5) The Profile also stated that Alloyd's shareholders would be available to furnish additional information to prospective purchasers. (*Id.* at G0001428)

[1] Record citations are to the docket entries in the District Court. Docket entries containing multiple tabs or pages are cited to a specific tab and/or page. For example, the citation "R. 56, Dep. Ex. 2 at 1" refers to docket entry number 56 (Appendix of Exhibits and Deposition Excerpts in Support of Plaintiffs' Motion for Summary Judgment), Deposition Exhibit No. 2 within the Appendix, at page 1. Citations to the Joint Appendix are designated by the prefix "J.A."

[2] Petitioners are referred to collectively as "Sellers."

In July 1989, Peat Marwick contacted Wind Point to see if Wind Point had any interest in purchasing Alloyd's stock and subsequently provided a copy of the Profile to Wind Point. (R. 56, Kracum Dep. 43-44, 48) Based on the information in the Profile, Wind Point submitted a written proposal to purchase the stock. (*Id.* at 55-56, Dep. Ex. 12) Sellers accepted Wind Point's bid, which was one of several received from prospective purchasers. (R. 56, Gustafson Dep. 72-73)

On October 17, 1989, Sellers and Wind Point executed a Letter Agreement setting forth the economic terms of Wind Point's proposed purchase of Sellers' stock.[3] (R. 56, Dep. Ex. 13) Under the terms of the Letter Agreement, Buyers were to pay Sellers approximately $38 million in total consideration (including notes, covenants, assumption of debt and an equity interest that McLean and Butler would retain in the new corporation). (*Id.*) Wind Point calculated the purchase price based on a multiple of 7.5 times Alloyd's earnings before interest and taxes (EBIT), determined by annualizing the interim financial figures provided by Sellers. (R. 56, Kracum Dep. 112, 115-16)

Both before and after signing the Letter Agreement, Wind Point attempted to learn as much as it could about Alloyd's business and financial condition. (*Id.* at 92-93, 95) McLean, acting as Sellers' spokesman on financial issues, provided Wind Point with interim operating results and annualized numbers for the entire year 1989 based on those interim numbers. (R. 56, Gustafson Dep. 30; McLean Dep. 197, 206-09; Kinney Dep. 183; Blank Dep. 23). These numbers reflected McLean's estimate of Alloyd's manufacturing costs based on his knowledge of the company's historical costs and day-to-day operating experience. (R. 56, McLean Dep. 51-52)

[3] The Letter Agreement specified that Wind Point would form a new corporation to purchase substantially all of the outstanding common stock of Alloyd. The new corporation established by Wind Point was incorporated in Delaware and named Alloyd Holdings, Inc. Collectively, respondents Wind Point and Holdings, which has been renamed Alloyd Co., Inc., are referred to as "Buyers."

Mclean also had discussions with Wind Point representatives during which he made numerous oral representations concerning Alloyd's financial condition. For example, McLean told Wind Point that: (1) any year-end adjustments to inventory would not be significant (R. 61, Argall Dep. 48); (2) no material adjustments to Alloyd's financial statements would occur at year end in 1989 (R. 61, Blank Dep. 25; Argall Dep. 45-46); (3) his gross profit margins were conservative and, if anything, understated Alloyd's income (R. 61, McLean Dep. 147, 230; Wallace Dep. 74-75); and (4) he expected Alloyd's annualized 1989 operating profit to be $4.85 million. (R. 56, Blank Dep. 68-71, 82)

On December 20, 1989, the parties executed a Stock Purchase Agreement, along with accompanying disclosure schedules and other ancillary documents. (J.A. 87) At that time, Sellers provided Buyers with Consolidated Interim Financial Statements for the ten months ended October 31, 1989, which are referred to in the Purchase Agreement as the "Latest Balance Sheet." (J.A. 115, 164-70)

Article IV of the Stock Purchase Agreement contains a series of representations and warranties made by Sellers "[a]s an inducement to Buyer to enter into this Agreement." (J.A. 111) Among other things, Sellers represented that:

(1) the financial statements provided to Holdings, including the Latest Balance Sheet, "present fairly on a consolidated basis the Company's financial condition and related results of operations as of the times and for the periods referred to therein" (J.A. 115 at ¶ 4D);

(2) between the date of the Latest Balance Sheet and the date of the Stock Purchase Agreement, there were no material adverse changes in "the business, financial condition, operating results, assets, operations or business prospects" of Alloyd (J.A. 117 at ¶ 4I); and

(3) Sellers had not failed to disclose any material facts that would adversely affect Alloyd's "business, financial condition, operating

results, assets, operations or business prospects" (J.A. 140 at ¶ 4Z).

At the closing on December 22, 1989, Sellers reaffirmed that all of their representations continued to be true and correct. (R. 56, Dep. Ex. 10)

Less than two months after the closing, Buyers discovered a significant inventory shortage in the course of the 1989 year-end audit of Alloyd. (R. 56, Kracum Dep. 263-66) McLean testified he was "shocked" by the disparity between the book and actual inventory figures. (R. 56, McLean Dep. 356-57) Gustafson testified he was troubled when he learned of the variance because "the material should have been there, or somebody played with the books somehow." (R. 56, Gustafson Dep. 107-08) As a result of this inventory discrepancy, it was apparent that Alloyd's profit margin and operating income were materially lower than Buyers were led to believe based on the Latest Balance Sheet.

On April 3, 1990, Peat Marwick issued its audited financial statements of Alloyd for the year ending December 31, 1989. (R. 56, Dep. Ex. 19) The audited balance sheet showed that Alloyd had $1.2 million less in inventory than shown on the Latest Balance Sheet provided to Buyers. (*Compare* R. 56, Dep. Ex. 19 *with* J.A. 164-70) That inventory shortfall had a significant impact on Alloyd's bottom line. EBIT, the number on which Wind Point had based its multiple-of-earnings purchase price, was nearly $1.5 million (roughly 35%) less than the figure derived from the financial data in the Latest Balance Sheet (and orally confirmed by McLean). (*Id.*)

As a result of Sellers' overstatement of Alloyd's inventory and operating income, Buyers paid substantially more for Alloyd's stock than they would have paid if the Latest Balance Sheet and other financial records of the company had fairly presented its 1989 results of operations and income. On February 11, 1991, Buyers sued Sellers in the United States District Court for the Northern District of Illinois. (R. 1) Buyers asserted two claims: (1) violation of Section 12(2) of

the Securities Act of 1933, 15 U.S.C. § 77l(2);[4] and (2) breach of the representations and warranties in the Stock Purchase Agreement. (*Id.*)

Opinions Below

After extensive discovery, the parties filed cross-motions for summary judgment. On May 29, 1992, the district court entered an unpublished Memorandum Opinion and Order granting Sellers' motion, ruling that section 12(2) does not apply to the transaction between the parties.[5] (J.A. 10) The district court relied on the Third Circuit's holding in *Ballay v. Legg Mason Wood Walker, Inc.*, 925 F.2d 682 (3d Cir.), *cert. denied*, 112 S. Ct. 79 (1991), that "Section 12(2) only applies to initial offerings and not to after-market trading." (J.A. 20)

Buyers appealed the judgment of the district court to the Seventh Circuit Court of Appeals. In an unpublished Order, the Seventh Circuit vacated the May 29, 1992 Order and remanded the case for further proceedings in light of its ruling in *Pacific Dunlop Holdings, Inc. v. Allen & Co.*, 993 F.2d 578 (7th Cir. 1993), *cert. granted*, 114 S. Ct. 907, *cert. dismissed*, 114 S. Ct. 1146 (1994).

In *Pacific Dunlop*, the Seventh Circuit held that section 12(2) applies to "any communication which offers any security for sale or confirms the sale of any security," including a stock purchase agreement. 993 F.2d at 595. (J.A. 80) In reaching this conclusion, the court focused on whether a sale of stock pursuant to a privately negotiated stock purchase agreement constituted a sale "by means of a prospectus or

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[4] The Securities Act of 1933 is referred to in this brief as the "1933 Act" or the "Act."

[5] The court denied Sellers' motion on two other grounds and declined to address the remaining grounds asserted in support of Sellers' motion. (J.A. 13-19) The court dismissed Buyers' pendent state-law breach of contract claim for lack of subject matter jurisdiction and denied Buyers' motion as moot. (J.A. 21-22)

oral communication" and whether Congress intended section 12(2) to apply to such a transaction. *Id.* at 582. (J.A. 47-48)

The Seventh Circuit began by analyzing the text of the statute. Noting that the term "prospectus," like the other key terms used in section 12(2), is defined "very broadly," the court concluded that a prospectus includes "a contract of sale or any other kind of written communication that disposes of a security." *Id.* at 582-83. The court found that the contract at issue in that case was a "prospectus" because it contained factual representations that formed the basis of the lawsuit. *Id.* at 583.

The court concluded that neither the context of section 12 nor the broader context of the 1933 Act as a whole required a definition of "prospectus" narrower than the broad definition in section 2(10). *Id.* at 584-88. The court also concluded that "[t]he legislative history of the 1933 Act does not require the context of the word 'prospectus' to have a more narrow definition [in section 12(2)] than that specified in section 2(10)." *Id.* at 592. Finally, the court held that nothing in the remedial structure of section 17(a) of the 1933 Act or section 10(b) of the 1934 Act required a different interpretation of section 12(2). *Id.* at 594.

Sellers filed a petition for *certiorari* from the judgment of the Seventh Circuit vacating and remanding the case to the district court. This Court granted Sellers' petition on March 7, 1994.

Subsequent Proceedings

Following remand from the Seventh Circuit, and shortly before filing their petition for *certiorari*, Sellers again moved for summary judgment on Buyers' section 12(2) claim. (R. 86-88) Sellers' motion asserted, among other things, that there was no evidence Sellers had made any material misrepresentations of fact. (R. 86 at 6-11) On March 24, 1994 the magistrate judge to whom the motion was referred entered a Report and Recommendation on the motion concluding that Sellers' motion should be denied. (R. 102)

The magistrate judge found the evidence raised an inference that Sellers had attempted to reassure Buyers that the interim financial figures were conservative and reliable. (R. 102 at 17) The Report and Recommendation summarized this evidence as follows:

> There is evidence that McLean responded to KPMG's concerns regarding the use of estimated inventory figures, by convincing plaintiffs and the KPMG representatives that a physical audit would be unnecessary and not cost effective. According to several people associated with both Wind Point or KPMG, McLean told them that his figures in the Latest Balance Sheet were conservative estimates and that any adjustments were more likely to be positive, than negative.

(*Id.*) The Report also concluded there was "evidence suggesting that [Sellers] performed no investigation, nor did they ask anyone else to perform one, as to whether the Latest Balance Sheet was fairly representative of Old Alloyd's financial condition." (*Id.* at 20)

With respect to the Stock Purchase Agreement, the Report stated that, "[f]ar from being a cautionary statement regarding Old Alloyd's financial condition on October 31, 1989, one could reasonably infer from the Agreement that defendants were confident that the Latest Balance Sheet was reliable." (*Id.* at 17) Thus, the magistrate judge concluded that "a reasonable juror could find that [Sellers] represented that the figures were free of material errors." (*Id.* at 22-23)

The magistrate judge also rejected Sellers' argument that Buyers were made whole by Sellers' $815,000 payment pursuant to the purchase price adjustment provision in the Stock Purchase Agreement. (*Id.* at 30) The magistrate judge concluded that the purchase price adjustment did not adequately compensate Buyers because they had paid a multiple of Alloyd's earnings and therefore "should also be entitled to recover any difference that would have made in the portion of the purchase price that was based on a multiple of those earnings." (*Id.* at 31)

SUMMARY OF ARGUMENT

Section 12(2) of the 1933 Act is a carefully worded provision that creates an expansive civil remedy for misrepresentations made by sellers of securities. It provides that any person who sells or offers to sell a security "by means of a written prospectus or oral communication" that contains materially misleading statements is liable to the purchaser of the security. The operative terms used by Congress in section 12(2) are defined broadly in the Act or, where not defined, have an expansive common meaning. Neither the text of section 12(2) nor any other provision of the 1933 Act expressly exempts privately negotiated sales of securities from the civil remedy provided to purchasers, or limits section 12(2) to public offerings.

Congress' use of the word "prospectus" in section 12(2) does not limit the scope of transactions to which that section applies. In defining "prospectus," Congress eschewed the somewhat narrower common meaning of the word and defined it expansively as a term of art – just as it did with the other defined terms in the Act. It is inconsistent with both the statutory definition and the drafting style of the Act as a whole to conclude, as Sellers argue, that Congress used the word "prospectus" as an indirect way of limiting section 12(2) to public offerings and excluding private transactions from the civil remedies of the Act.

A straightforward reading of section 12(2) as encompassing both public and private transactions not only comports with the text, but is confirmed by the structure of the 1933 Act as a whole. When Congress intended to exempt specific categories of securities or transactions from the Act, it did so explicitly, as in section 3 (exempt securities) and section 4 (exempt transactions). That Congress did not expressly provide an exemption from section 12(2) for privately negotiated transactions is strong evidence Congress did not intend such an exemption. Moreover, it is inconsistent with the operation of the civil remedies provided in the Act to construe section 12(2) as creating a remedy for some, but not all, purchasers of

securities sold through materially misleading statements by sellers.

Applying section 12(2) to privately negotiated sales of securities is fully consistent with the broad remedial purpose of full *and* fair disclosure the Act was designed to ensure. The registration requirement of the Act focuses on providing information to investors who need it, while the civil remedy provisions address the truthfulness of representations made by sellers. Private offerings of securities are exempted from the registration requirements because parties to such transactions are deemed capable of obtaining the kind of information required in a registration statement. Having *access* to information, however, does not guarantee that the information obtained is *truthful*. The Act therefore does not draw distinctions between "public" and "private" purchasers when providing remedies for false or misleading statements of material fact.

In accord with the text of section 12(2) and the structure of the 1933 Act, the appellate courts for fifty years have consistently upheld section 12(2) claims arising out of privately negotiated sales of securities. Since shortly after passage of the Act, the SEC has similarly construed section 12(2) and the definition of "prospectus" in the Act broadly enough to provide a remedy for misrepresentations made in such transactions. Given this consistent construction by the courts of appeals and the agency responsible for administering the Act, the narrow construction of section 12(2) urged by Sellers would upset the justified expectations of the legal and investment communities.

Sellers rely on legislative history and policy arguments, neither of which provide a sufficient basis for a constricted reading of section 12(2). The legislative history is largely silent on the question presented in this case. Nothing in the sparse legislative history of section 12(2) expresses Congress' intent to exclude privately negotiated transactions from the ambit of that section. Nor do general statements of intent to protect the "investing public" or to regulate offerings of stock to "the public" justify reading into section 12(2) a limitation that Congress itself did not expressly create. Similarly, Sellers' policy arguments cannot overcome the broad reading of section 12(2) consistent with the text, structure and remedial purpose of the Act.

Finally, *amicus* Securities Industry Association offers a different limitation, arguing that only issuers of securities are subject to section 12(2). Going far afield of the type of transaction at issue in this case, SIA asks the Court to decide whether securities firms can be held responsible for negligent misstatements in their research reports and similar communications with their customers. That issue was not raised below, is not before the Court, and need not be decided to resolve the question presented in this case.

ARGUMENT

I. The Language And Structure Of The Statute Demonstrate That Section 12(2) Applies To Private Offerings.

This case poses a narrow and specific question of statutory construction: "Whether Section 12(2) of the Securities Act of 1933 extends to a privately negotiated sale of stock."[6] (Pet. Br. i) Sellers focus the question even more precisely in their brief as "[w]hether a Section 12(2) remedy applies to privately negotiated transactions that Section 4 exempts from the registration requirements of Section 5 of the 1933 Act." (Pet. Br. 11) Both the text of section 12(2) and the structure of the 1933 Act as a whole refute Sellers' argument that the remedial provisions of section 12(2) are limited to misrepresentations made in public offerings of securities.

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[6] Although Buyers accept the substance of the question presented by Sellers, it would more accurately be framed as: "whether section 12(2) of the Securities Act of 1933 should be limited to public offerings of stock." As discussed below, section 12(2) has been construed consistently to apply to privately negotiated sales since shortly after passage of the Act. The construction urged by Sellers would impose a new limitation on the statute.

A. The Text Of The Statute Does Not Limit Section 12(2) To Public Offerings.

The analysis of this issue must start with the text of the statute itself. *See, e.g., Reves v. Ernst & Young*, 113 S. Ct. 1163, 1169 (1993); *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 685 (1985). The limitation Sellers ask this Court to impose on section 12(2), however, is not expressed in the text of the statute. This is the best evidence that Congress did not intend to exclude purchasers in private transactions from obtaining a remedy under section 12(2) for material misrepresentations by the seller. *See Pinter v. Dahl*, 486 U.S. 622, 653 (1988) ("ascertainment of congressional intent with respect to the scope of liability created by a particular section of the Securities Act must rest primarily on the language of that section").

1. The Language of Section 12(2) Encompasses Both Public and Private Sales of Securities.

The language of section 12(2) creates a broad remedy for purchasers of securities. Congress neither used the term "public" in defining the types of purchasers entitled to that remedy, nor expressly exempted "private" transactions from its application. Rather, section 12(2) provides a remedy against "[a]ny person" who "offers or sells a security . . . by means of a prospectus or oral communication" that includes a material misstatement or omission. 15 U.S.C. § 77l(2). Congress did not expressly limit application of the section to issuers of securities, the entities that generally make initial offerings of stock to the public.

The defined terms used by Congress in drafting section 12(2) similarly demonstrate that the civil remedy was intended to apply broadly. Section 2(3) of the Act defines "sell" expansively to include "every contract of sale or disposition

of a security or interest in a security, for value."[7] 15 U.S.C. § 77b(3). Similarly, the term "offer" is defined to include "every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security, for value." *Id.* Section 2(10) provides that, "[u]nless the context otherwise requires," the term "prospectus" means "any prospectus, notice, circular, advertisement, letter, or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security." 15 U.S.C. § 77b(10). Read together, these broadly defined terms reflect an intent to create a remedy for materially misleading statements in communications used to offer or sell securities.[8]

Congress' use of the undefined term "oral communication" in section 12(2) further demonstrates that the civil remedy created in that section is not limited to public offerings. In the absence of a statutory definition, this Court will construe a statutory term "in accordance with its ordinary or natural meaning." *FDIC v. Meyer*, 114 S. Ct. 996, 1001 (1994). The ordinary and natural meaning of "oral communication" is obviously broad enough to encompass

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[7] If, as Sellers contend, the 1933 Act was intended to reach only public offerings, not privately negotiated sales, it is unlikely Congress would have defined "sale" – one of the critical operative words in the statute – to include "*every*" transaction or contract that disposes of a security, rather than sales "to the public."

[8] This Court read such similarly all-inclusive language in section 17(a)(1) of the Act broadly in *United States v. Naftalin*, 441 U.S. 768 (1979). Rejecting an argument that section 17(a)(1) only prohibited fraud directed against investors, the Court held that the expansive terms used by Congress did not require "that the victim of the fraud be an investor – only that the fraud occur 'in' an offer or sale." *Id.* at 772. The Court has also relied on Congress' "expansive" definitions of related terms in a statutory provision as probative of whether a particular term should be construed broadly or narrowly. *See Pennsylvania Dep't of Public Welfare v. Davenport*, 495 U.S. 552, 558 (1990).

representations made in private transactions.[9] Other than messages broadcast over radio or television, which are expressly covered by the definition of "prospectus," *see* 15 U.S.C. § 77b(10), oral communications generally occur in limited-audience contexts such as face-to-face meetings or telephone conversations. Such communications are often the principal medium through which representations are made in privately negotiated transactions.

Nor did Congress limit section 12(2) to public offerings through section 4 of the Act, which exempts private transactions from the registration requirements of the Act. Section 4 provides in relevant part:

> The provisions *of section 77e* [section 5] of this title shall not apply to –
> (1) transactions by any person other than an issuer, underwriter, or dealer.
> (2) transactions by an issuer not involving any public offering.

15 U.S.C. § 77d(1)-(2) (emphasis added). Section 4 contains no reference to, much less any exemption from, the remedial provisions of section 12(2).

Thus, neither section 12(2) nor section 4 of the Act creates an express exemption from the civil remedies of section 12(2) for privately negotiated sales of securities. To the contrary, Congress drafted section 12(2) expansively to encompass misrepresentations made in the full array of communications used to sell securities, while carefully wording the private offering exemption in section 4 to apply only to

[9] The meaning of "oral communication" cannot be narrowly cabined through the doctrine of *ejusdem generis* – that general words following specific words in a statutory list will be construed as limited to objects similar in nature to those encompassed by the specific term. First, as discussed *infra*, the only other term that precedes "oral communication" in describing the communications covered by section 12(2), "prospectus," is itself defined expansively, not narrowly. Second, the Court has stated that the doctrine does not apply to terms "made separate and distinct from one another by Congress' use of the disjunctive." *Garcia v. United States*, 469 U.S. 70, 75 (1984). Here, "prospectus" and "oral communication" are used in the disjunctive.

the Act's registration requirement.[10] As stated by Professor Loss: "To start with what is clearest, the Section [12(2)] applies to all sales of securities, whether or not registered and whether or not the particular security or transaction is exempted from § 5 . . . ."[11] L. Loss & J. Seligman, *Securities Regulation* 4198 (3d ed. 1992); *see also* T. Hazen, *The Law of Securities Regulation* 305 (2d ed. 1990) (section 12(2) has no express limitation to "distributions" and thus "applies regardless of the context of the sale").

Reading section 12(2) as applicable to privately negotiated sales is consistent with the Court's decisions construing the 1933 Act. In *Landreth Timber Co. v. Landreth*, 471 U.S. 681, 692 (1985), the Court held that the sale of all the stock of a corporation constituted a sale of a security within the scope of the 1933 and 1934 Acts. The Court rejected the argument that the Acts were not intended to cover "privately negotiated transactions involving the transfer of control to

[10] In attempting to overcome this reading of the text, Sellers assert that the phrase "by means of a prospectus or oral communication" in section 12(2) is superfluous unless read as limiting the section to "some, but not all, sales of securities." (Pet. Br. 21-22) From this dubious premise, Sellers leap to the erroneous conclusion that the phrase *must* limit section 12(2) to public offerings. Sellers' argument depends on the proposition that, absent the phrase "by means of a prospectus or oral communication," the language of section 12(2) would provide a remedy for misrepresentations in all sales of securities. But the syntax of section 12(2) does not support this proposition. To the contrary, deletion of the "by means of . . ." phrase makes section 12(2) meaningless, because without it there is no referent for the clause "which includes an untrue statement of material fact . . . ." The words "by means of a prospectus or oral communication" are the operative words that give section 12(2) meaning; they do not limit a broader meaning that it would have without them.

[11] The SEC has expressed precisely the same view of the relationship between the exemption for private transactions and the Act's civil remedies. In Rule 506 of Regulation D, 17 C.F.R. § 230.506, the SEC sets forth the criteria for compliance with the private offering exemption in section 4(2). The preliminary notes to Regulation D explain that the transactions exempted from registration under it "are not exempt from the antifraud, civil liability, or other provisions of the federal securities laws."

'entrepreneurs'." In support of this conclusion, the Court noted that "although § 4(2) of the 1933 Act, 15 U.S.C. § 77d(2), exempts transactions not involving any public offering from the Act's registration provisions, there is no comparable exemption from the antifraud provisions." *Id.*

Sellers suggest that *Landreth* is inapposite because it dealt only with the question whether a privately negotiated sale of stock "involved the sale of a 'security' within the meaning of the 1934 Act." (Pet. Br. 11-12) Contrary to Sellers' argument, neither the Court's holding nor its reasoning in *Landreth* was limited to the 1934 Act. Rather, the Court expressly (and repeatedly) stated that the transaction in that case constituted a sale of a security within the meaning of the securities "Act*s*." 471 U.S. at 683, 687, 688, 692, 694, 697 (emphasis added).

The applicability of *Landreth* to the 1933 Act, and to section 12(2) in particular, is confirmed by *Gould v. Ruefenacht*, 471 U.S. 701 (1985), a decision Sellers' brief ignores. In *Gould*, the purchaser of a block of stock in a privately negotiated transaction sued the seller under sections 12(2) and 17(a) of the 1933 Act and under Rule 10b-5. The purchaser had relied on financial documents and oral representations by the seller, who owned all of the company's stock prior to the sale. *Id.* at 702-03. The question presented was "whether the sale of 50% of the stock of a company is a securities transaction subject to the antifraud provisions of the federal securities laws (the Acts)." *Id.* at 702. The Court held that both Acts, and hence the antifraud provisions of both, applied for the reasons stated in *Landreth*. *Id.* at 704.

Like *Landreth* and *Gould*, this case involves the sale of a business by its controlling stockholders. Sellers actively solicited purchasers for their stock and distributed a "Profile" describing the attributes of the company to potential buyers. In follow-up discussions with respondent Wind Point, Sellers made a series of oral representations about the company's business, in particular the stability of its margins, in order to seal the deal. Finally, as an inducement to Buyers to enter into a binding contract for their shares, Sellers made deta..ed written representations regarding the financial condition of the company. Despite their extensive due diligence, Buyers were unable to discover that a number of Sellers' oral and written representations were untrue until after the closing. This transaction comes squarely within the terms of section 12(2).

2. The Courts of Appeal Have Consistently Applied Section 12(2) to Private Transactions.

Sellers erroneously state that the courts of appeal "are in conflict on th[e] issue" in this case. (Pet. Br. 11) The appellate courts are *not* divided on the question whether the civil remedies in section 12(2) of the 1933 Act apply to "private" sales exempt from registration by section 4 of the Act. To the contrary, as the Seventh Circuit stated in *Pacific Dunlop*, "[t]he courts have consistently held that the section 4 exemptions do not apply to section 12(2)." 993 F.2d at 587. *Accord Metromedia Co. v. Fugazy*, 983 F.2d 350, 361 (2d Cir. 1992) (stating that section 12(2) has "consistently been applied to private as well as public offerings of securities"), *cert. denied*, 113 S. Ct. 2445 (1993).

The decisions expressly stating that section 12(2) applies to private transactions exempt under section 4 of the Act span nearly fifty years. *See, e.g., Haralson v. E.F. Hutton Group, Inc.*, 919 F.2d 1014, 1032 (5th Cir. 1990) (holding that application of section 12(2) is not limited to public offerings); *Nor-Tex Agencies, Inc. v. Jones*, 482 F.2d 1093, 1099 (5th Cir. 1973) (holding that section 4(2) does not exempt a private transaction from "the anti-fraud provisions of section 12(2)"), *cert. denied*, 415 U.S. 977 (1974); *Woodward v. Wright*, 266 F.2d 108, 111, 114-15 (10th Cir. 1959) (stating that section 12(2) provides a remedy for "misrepresentation in the sale of the securities generally, whether registered or exempt from the registration requirements under [section 4]"); *Moore v. Gorman*, 75 F. Supp. 453, 456 (S.D.N.Y. 1948) (holding that

section 4 "does not purport to, nor does it, confer any exemption from the civil liability imposed by section 12(2)").[12]

In these decisions, the courts have found the statutory language dispositive in concluding that transactions exempt under section 4 are nevertheless subject to section 12(2). For example, the Fifth Circuit explained: "By its express terms, the private offer exemption only exempts a transaction from the registration requirements of sections 5 and 12(1), and does not exempt a transaction from the anti-fraud provisions of sections 12(2) of the '33 act or Rule 10b-5 under the '34 act." *Nor-Tex Agencies*, 482 F.2d at 1099 (citations omitted). The appellate courts have also repeatedly upheld section 12(2) claims predicated on private oral conversations between sellers and purchasers. *See, e.g., Metromedia*, 983 F.2d at 361; *Currie v. Cayman Resources Corp.*, 835 F.2d 780, 783 (11th Cir. 1988); *Schillner v. H. Vaughan Clarke & Co.*, 134 F.2d 875, 876-77 (2d Cir. 1943).

Sellers do not cite any case holding that section 12(2) is inapplicable to private transactions exempt under section 4 of the Act. Instead, the decisions cited by Sellers (Pet. Br. 12-14) address a different issue: whether section 12(2) applies only to "initial" offerings of stock, as opposed to "secondary market trading." *See Ballay v. Legg Mason Wood Walker, Inc.*,

[12] Other appellate court decisions have upheld section 12(2) claims arising out of a variety of private transactions without expressly deciding the question. *E.g., Wright v. National Warranty Co.*, 953 F.2d 256 (6th Cir. 1992) (sale of unregistered securities pursuant to private placement memorandum); *Acme Propane, Inc. v. Tenexco, Inc.*, 844 F.2d 1317 (7th Cir. 1988) (private placement of unregistered securities to "sophisticated, informed" investors); *Currie v. Cayman Resources Corp.*, 835 F.2d 780 (11th Cir. 1988) (private offering of limited partnership interests); *Adalman v. Baker, Watts & Co.*, 807 F.2d 359 (4th Cir. 1986) (private offering of limited partnership interests); *Austin v. Loftsgaarden*, 675 F.2d 168 (8th Cir. 1982) (private offering of limited partnership interests); *Schillner v. H. Vaughan Clarke & Co.*, 134 F.2d 875 (2d Cir. 1943) (face-to-face oral representations inducing investment in company); *Cady v. Murphy*, 113 F.2d 988 (1st Cir.) (privately negotiated sale of voting trust certificates), *cert. denied*, 311 U.S. 705 (1940).

925 F.2d 682, 687-88 (3d Cir.), *cert. denied*, 112 U.S. 79 (1991); *First Union Discount Brokerage Services, Inc. v. Milos*, 997 F.2d 835, 843 (11th Cir. 1993); *Gross v. Diversified Mortgage Investors*, 431 F. Supp. 1080, 1095 (S.D.N.Y. 1977), *aff'd mem.*, 636 F.2d 1201 (2d Cir. 1980). *Ballay* involved a claim against a brokerage firm based on misstatements in the firm's research reports on a publicly traded company. 925 F.2d at 686. *First Union* involved a claim against a discount broker for trading through a margin account. 997 F.2d at 840. None of these cases addressed claims against sellers of stock in private transactions exempt under section 4.

As the Seventh Circuit pointed out in *Pacific Dunlop*, "[t]he public/private and initial/secondary are two entirely different questions." 993 F.2d at 585-86 n.12. For example, an "initial offering" of stock can be either public – via a widely disseminated registered *offering* – or private – pursuant to a limited offering exempt under section 4(2) of the Act. Similarly, a "public" offering can be either an initial offering of stock by an issuer or a secondary offering by a large stockholder. In short, the two dichotomies define related, but different, categories of transactions.

The *Ballay* decision illustrates this difference. In *Ballay*, the court held that a brokerage firm's oral communications relating to "a *public market transaction*" were not within the scope of section 12(2). (Pet. Br. 13, emphasis added) The *Ballay* court focused exclusively on the distinction between initial and secondary offerings. The application of section 12(2) to a privately negotiated sale by controlling shareholders was never an issue in that case, and the court did not address the public/private distinction urged by Sellers here.

The prolonged period of time over which the appellate courts have consistently read section 12(2) as applicable to private transactions is itself a reason to affirm that construction. That these courts have found the statutory language clear enough to obviate any need for extensive analysis or resort to legislative history supports the conclusion that the text of the statute answers the question presented. *Cf. United States v. Naftalin*, 441 U.S. 768, 779 (1979) (Where Congress has

conveyed its purpose clearly, "we decline to manufacture ambiguity where none exists.") (citations omitted). Where the lower courts have been unanimous in a particular reading of a remedial provision, "such a settled construction of an important federal statute should not be disturbed unless and until Congress so decides." *Reves v. Ernst & Young*, 494 U.S. 56, 74 (1990) (Stevens, J., concurring).[13] At a minimum, the consistent application of section 12(2) to private transactions should place on Sellers the burden of demonstrating that the statute cannot reasonably be read the way courts have read it for fifty years.

B. The Use Of The Term "Prospectus" Does Not Limit Section 12(2) To Public Offerings.

Sellers attempt to fashion a textual argument based on one word in section 12(2) – "prospectus." They argue that what Congress failed to do directly, by explicitly limiting section 12(2) to public offerings, it did indirectly by using the term "prospectus" in section 12(2). It is simply too much to believe that Congress intended to impose such a significant limitation on the scope of the Act's civil remedy through the use of this one word.

Sellers contend that "prospectus" imposes a limitation on the types of *transactions* covered by section 12(2) – public offerings vs. private transactions. The phrase "by means of a prospectus or oral communication," however, addresses types of *communications*, not types of transactions. When Congress intended to exempt particular types of transactions, it did so explicitly, as in section 4. Similarly, when Congress intended to exempt particular types of securities, it did that explicitly

[13] Although a majority of the Court recently found this principle inapplicable in *Central Bank of Denver v. First Interstate Bank of Denver*, 114 S. Ct. 1439, 1452 (1994), that case did not present a similarly settled construction of an express statutory remedy. Rather, as the Court noted, numerous courts had questioned whether it was appropriate to append an implied cause of action for aiding and abetting to the implied right of action under Rule 10b-5. *Id.* at 1444.

too, as in section 3 of the Act. 15 U.S.C. § 77c. It is wholly inconsistent with this straightforward drafting style for Congress to have taken an indirect approach to limiting the transactions covered by section 12(2).

Furthermore, neither the dictionary definition of "prospectus" nor the use of that term in section 12(2) supports limiting section 12(2) to documents or oral statements in connection with public offerings of stock. As discussed above, section 2(10) of the Act defines "prospectus" broadly. If Congress had intended "prospectus" to have its common meaning, it need not have defined the word at all, just as it did not define "oral communication." Alternatively, Congress could have reiterated in section 2(10) what Sellers argue was the "well-established meaning" in 1933 and defined "prospectus" as "[a] document published by a company or corporation . . . setting forth the nature and objects of an issue of shares . . . and inviting the public to subscribe to the issue." *Black's Law Dictionary* 1451 (3d ed. 1933). Congress did neither.

Instead, Congress chose to define "prospectus" by beginning with the word itself, then adding other terms that can only be read to broaden its scope. The repetition of the word "prospectus" as one in a series of words defining the term evidences Congress' intent that "prospectus" as used in the Act was not limited to its common dictionary definition.

The maxim *noscitur a sociis* – that a word is known by the company it keeps – does not compel a constricted reading of "prospectus." That maxim counsels that words in a series should be construed to have related, not identical, meanings. *Cf. Reves*, 494 U.S. at 64 (explaining that the definition of one term in a definitional series does not control the meaning

of other terms in the series).[14] Here, if the various terms used in the definition of "prospectus" – such as "letter" or "communication" – are read as mere synonyms for the dictionary definition of "prospectus," they would be superfluous. These additional terms must be read as having different, but related, meanings that each add something to the dictionary definition. *See Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 862 (1984) (regulatory statute's "listing of overlapping, illustrative terms was intended to enlarge, rather than to confine" the scope of the statute).[15]

Sellers argue that the only characteristic the various terms in the definition of "prospectus" could possibly have in common is the connotation of a public offering. (Pet. Br. 20-21) Nothing in section 2(10) or section 12(2) compels this conclusion. An equally plausible principle of relatedness, and one more consistent with the structure and context of section 12(2), is that each term connotes a communication that conveys some information or makes some representation about the securities being offered for sale – whether to the public at large or to a single investor. *See Pacific Dunlop*,

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[14] In *Reves*, this Court addressed whether a particular instrument constituted a "note" as used in the series of terms defining "security" in the securities acts. The Court rejected defendant's argument that the instrument in question failed to meet the *Howey* test for identifying an "investment contract," another of the terms used to define "security." The Court stressed that these two defining terms had different meanings. "To hold that a 'note' is not a 'security' unless it meets a test designed for an entirely different variety of instrument 'would make the Acts' enumeration of many types of instruments superfluous'." 494 U.S. at 64, quoting *Landreth*, 471 U.S. at 692.

[15] The Third Circuit in *Ballay* asserted that Congress "more simply could have drafted Section 12 to govern all written or oral communications." *Ballay*, 925 F.2d at 689. As Professor Loss has explained, "it probably would not have occurred to the draftsmen – indeed, they very likely would have recoiled from the idea if it had been suggested – to say *written offer* rather than *prospectus* in section 12(2) when they had just defined *prospectus* to mean exactly that. In short, section 12(2) must be read as if it said 'by means of a written or oral communication'." L. Loss, *Securities Act Section 12(2): A Rebuttal*, 48 Bus. Law. 47, 51 (1992).

993 F.2d at 588 (key to defining "prospectus" lies in "whether the substance of the words used" offers to sell or confirms the sale of a security).[16]

The construction given to the term "prospectus" by the SEC confirms the Seventh Circuit's reading of section 12(2). In a 1941 opinion, the general counsel of the SEC explained that the term "prospectus" as defined in section 2(10) of the Act "covers more than the kind of formal document which the layman ordinarily has in mind when he uses the term."

> Under the Act a "prospectus" includes every kind of written communication which attempts or offers to dispose of, or solicits an offer to buy, a security for value, *or which constitutes a contract of sale* or disposition of a security for value.

SEC Release No. 33-2623, 11 Fed. Reg. 10964 (July 25, 1941) (emphasis added). Thus, "prospectus" should be read to cover a wide variety of communications, including a contract of sale or any other document that effectuates the sale of a security.[17]

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[16] *Amicus* Securities Industry Association ("SIA") attacks the Seventh Circuit's opinion in *Pacific Dunlop* as holding that "any document *connected with the sale of a security* qualifies as a 'prospectus'." (SIA Br. 8; emphasis added) This misstates the Seventh Circuit's holding. What the court actually held was that "section 12(2) applies to any communication which offers any security for sale or confirms the sale of any security," a significantly narrower holding. 993 F.2d at 595. (J.A. 80)

[17] The principal authority cited by Sellers, *Ballay*, suggests that the term "prospectus" as defined in section 2(10) is limited to the specific type of prospectus required by section 10 of the Act, 15 U.S.C. § 77j. 925 F.2d at 688-89. (*See* Pet. Br. 13) That ignores the plain language of section 2(10), which is broader than section 10. The SEC has noted the distinction between the broad meaning of "prospectus" in section 2(10) and the "formal prospectus" referred to in section 10 of the Act, which must accompany a registration statement. The 1941 opinion explains that a "formal prospectus" is a "prospectus that meets the requirements of section 10," while the term "prospectus" as used in section 2(10) includes any document that offers a security for sale or constitutes a contract for sale of a security. SEC Release No. 33-2623, 11 Fed. Reg. 10964 (July 25, 1941). There is nothing in the text of section 12(2) suggesting that Congress intended to limit "prospectus" to a "formal" section 10 prospectus.

This interpretation of a statutory term of art by the SEC, especially in light of its relatively close temporal proximity to enactment of the statute, should be given substantial weight. This Court has long recognized that "considerable weight should be accorded to an executive department's construction of a statutory scheme it is entrusted to administer." *Chevron*, 467 U.S. at 844; *accord National R.R. Passenger Corp. v. Boston & Maine Corp.*, 112 S. Ct. 1394, 1401 (1992) ("Judicial deference to reasonable interpretations by an agency of a statute that it administers is a dominant, well settled principle of federal law.").

In sum, the definition of the term "prospectus" makes clear that Congress did not intend to limit that term to its narrower common definition. Rather, section 2(10) defines the term to include a wide range of written communications used to sell securities. This expansive definition is consistent with its companion term, "oral communication," and with the other expansively defined terms used in section 12(2). There is nothing in the context of section 12(2) that requires "prospectus" to have a narrower meaning in that section in order to limit the Act's civil remedies to public offerings.

C. The Structure Of The 1933 Act Confirms That Private Offerings Are Not Exempt From Section 12(2).

In construing a statutory provision, it is appropriate to examine not only the particular clause in question and the specific section in which it resides, but also the context of the statute as a whole. *See, e.g., Coit Independence Joint Venture v. FSLIC*, 489 U.S. 561, 573-74 (1989). This is particularly true when construing the securities laws. *See SEC v. National Securities, Inc.*, 393 U.S. 453, 466 (1969). Here, the other provisions of the 1933 Act, and the way in which those provisions are interrelated, confirm that section 12(2) is not limited to "public" offerings of stock.

As Professor Loss has explained, the 1933 Act has just two important substantive provisions: section 5 and section 17. 9 L. Loss & J. Seligman, *Securities Regulation* 4219 (3d ed. 1992). Section 5 contains the basic requirement that all

securities sold in interstate commerce through "any prospectus or otherwise" must be registered. 15 U.S.C. § 77e. Section 17 proscribes fraud in connection with offers and sales of securities in interstate commerce. *Id.* § 77q.

Sections 11 and 12 of the Act provide civil remedies to purchasers of securities damaged by violations of these provisions. Section 11 provides that any person who purchases a registered security may sue to recover damages suffered as a result of any material omission or misstatement in the registration statement. The potential defendants under section 11 include the issuer, its directors, those who sign the registration statement, underwriters, and experts whose work is incorporated in the registration statement. 15 U.S.C. § 77k(a). Section 12(1) provides that any person who purchases unregistered securities offered or sold in violation of section 5 may sue the seller for rescission. *Id.* § 77l(1). Finally, section 12(2) provides that the purchaser of stock sold by means of a materially misleading prospectus or oral communication may sue the seller for rescission or rescissory damages. *Id.* § 77l(2).

Sections 3 and 4 of the Act set forth a series of exemptions from the registration requirement of section 5 and other provisions of the Act. Section 3 lists several categories of securities exempt from the Act. 15 U.S.C. § 77c. Sections 12(2) and 17, however, provide that the exemptions in section 3 do not apply to those antifraud provisions. *Id.* §§ 77l(2), 77q(c). Section 4 contains a narrower set of exemptions; it identifies certain transactions to which the registration requirements of section 5 do not apply, but does not provide an exemption from any other provision of the Act. *Id.* § 77d. Read together, sections 3, 4, and 12 demonstrate that when Congress meant to exempt a particular type of security or transaction from one or more provisions of the Act, it did so

explicitly.[18] This makes the absence of an express "private transaction" exclusion in section 12(2) all the more telling. *See Patterson v. Shumate*, 112 S. Ct. 2242, 2246 (1992).

Sellers argue that section 12(2) "cannot reasonably be construed as applicable to private transactions while the closely related Section 12(1) plainly applies only to public offerings." (Pet. Br. 29) This is a *non sequitur*. Section 12(1) has no application to the various sales of securities exempted from the Act's registration requirements by section 3, yet those sales are expressly made subject to section 12(2).[19] It is no less reasonable for section 12(2) to apply to private transactions exempted from registration under section 4, even though such transactions are not subject to section 12(1).

Moreover, the civil remedy created in section 11 for misrepresentations in registration statements is not limited to public offerings. Privately negotiated sales of stock can also be registered, and Section 11 draws no distinction between purchasers of registered shares in a public offering and purchasers of such shares in privately negotiated

[18] This point is confirmed by the language of section 13 of the Act, which sets forth the limitation periods for the private rights of action created in sections 11 and 12. Section 13 establishes a three-year period of repose as follows:

> In no event shall any such action be brought to enforce a liability created under section 77k [section 11] or 77l(1) [section 12(1)] of this title more than three years after the security was bona fide *offered to the public*, or under section 77l(2) [section 12(2)] of this title more than three years *after the sale*.

15 U.S.C. § 77m (emphasis added). This section illustrates that Congress knew how to specify public offerings when that was its intent.

[19] For example, by virtue of Regulation D promulgated under section 3(b), certain offerings of securities less than $5,000,000 are exempt from the Act's registration requirements, and thus from section 12(1). 17 C.F.R. § 230.505. Section 12(2), however, applies to offerings regardless of dollar amount because the section 3 exemptions do not apply to section 12(2).

deals.[20] It would be incongruous to construe the Act as providing a "private" buyer of registered shares a remedy under section 11 for the seller's misrepresentations, but providing the same buyer no remedy under section 12(2) for misrepresentations made by a seller of unregistered shares in a private transaction.

Nor do sellers gain anything from their comparison of section 12(2) to section 17 of the Act, which outlaws fraud "in the offer or sale of any securities by the use of any means or instruments of transportation or communication in interstate commerce." 15 U.S.C. § 77q. Sellers argue that because section 17 does not refer to sales "by means of a prospectus or oral communication," the inclusion of this phrase in section 12(2) demonstrates that section 12(2) "was not intended to be applicable to sales outside the public offering context." (Pet. Br. 32)

Once again, Sellers' argument is a *non sequitur* because section 17 has significantly broader coverage than section 12(2) even if section 12(2) is read to apply to private transactions. For example, section 17 makes it unlawful for a person to tout securities through false or misleading statements even if no one actually purchases the securities. Section 12(2), by contrast, provides a private remedy only to a person who actually purchased stock from the person making the misrepresentation. *See Pinter v. Dahl*, 486 U.S. 622, 644 (1988) (purchase requirement confines section 12 liability to situations in which sale has taken place). Similarly, section 17(a)(3) prohibits persons from engaging in "any transaction, practice, or course of business" that operates as a fraud on a purchaser of securities. 15 U.S.C. § 77q(a)(3). This provision reaches a broader range of conduct than section 12(2), which is limited to misrepresentations in written or oral communications used to sell securities to a purchaser.

[20] Even where a registration statement is not required, section 6 of the Act provides that "[a]ny securities may be registered." 15 U.S.C. § 77f. *See, e.g., Westinghouse Elec. Co. v. '21' Int'l Holdings, Inc.*, 821 F. Supp. 212 (S.D.N.Y. 1993) (privately negotiated exchange of assets for $115 million in registered Westinghouse shares).

Construing section 12(2) as limited to public offerings would create a significant gap in the remedial structure of the 1933 Act. The Act provides a series of remedies for buyers of stock sold in violation of the substantive proscriptions in sections 5 and 17. Section 11 provides *every* buyer of registered securities with a remedy for misrepresentations in a registration statement. Section 12(1) provides a remedy to *every* buyer of unregistered securities sold in violation of section 5. Under Sellers' construction of section 12(2), however, only *some* buyers of unregistered shares sold through material misrepresentations would have a remedy under the Act against the seller who made the misrepresentations.

Sellers assert that Congress must have intended this gap in the 1933 Act remedies because "the 1934 Act created broad fraud remedies for buyers (as well as sellers) in connection with private (as well as public) sales of stock." (Pet. Br. 32) This argument rests on a faulty premise. The private right of action under section 10(b) of the 1934 Act, 15 U.S.C. § 78j(b), is a remedy implied by the courts, not expressly created by Congress.[21] *See Musick, Peeler & Garrett v. Employers Ins. of Wausau*, 113 S. Ct. 2085, 2088 (1993). The legislative history of section 10(b) does not indicate that Congress even considered providing such a private right of action. *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 729 (1975). Moreover, the SEC did not adopt Rule 10b-5, 17 C.F.R. § 240.10b-5, which eventually served as the impetus for the creation of the private right of action to enforce section 10(b), until 1942.

There is no reason to infer that Congress intended in 1933 to exclude buyers of securities in private transactions from the scope of section 12(2) because they were adequately protected by antifraud remedies under the 1934 Act. Congress could not know that courts would eventually infer such a private right of action from an SEC rule adopted eight years

[21] While Congress created express rights of action in the 1934 Act, *see* 15 U.S.C. §§ 78i, 78p, 78r, none of those would apply to the kind of transaction at issue in this case.

after the Act. *See Blue Chip Stamps*, 421 U.S. at 730. As stated by Professor Loss, "it is almost inconceivable that these two great statutes – which repeatedly have been treated as *in pari materia* – were meant to afford no civil remedy whatsoever to the great bulk of investors who do not participate in distributions." 9 L. Loss & J. Seligman, *Securities Regulation* 4220 (3d ed. 1992).

II. Application Of Section 12(2) To Private Transactions Is Consistent With The Remedial Purpose Of The Statute.

The construction of section 12(2) that follows from the text of the provision and the structure of the Act is also fully in accord with the remedial purpose of the Act. This Court has noted repeatedly that "Congress had 'broad remedial goals' in enacting the securities laws and providing civil remedies." *Pinter*, 486 U.S. at 653, quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 200 (1976). Section 12(2) serves the statute's broad remedial goals by "creat[ing] potential civil liability for a seller of securities in favor of the purchaser for misleading statements or omissions in connection with the transaction." *Ernst & Ernst*, 425 U.S. at 200 n.27.[22] Accordingly, section 12(2) should be construed "not technically and restrictively, but flexibly to effectuate its remedial purposes." *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972), quoting *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963).

[22] Sellers argue that section 12(2) is not "simply another 'antifraud provision'," but rather a "unique" fiduciary duty remedy. (Pet. Br. 15-16) This Court has repeatedly described section 12(2) as an antifraud remedy. *See, e.g., Reves*, 494 U.S. at 80 (Rehnquist, C.J., dissenting) (referring to section 12(2) as one of "the 1933 Act's antifraud provisions"); *Randall v. Loftsgaarden*, 478 U.S. 647, 655 (1986) ("Section 12(2) specifies the conduct that gives rise to liability for prospectus fraud and expressly creates a private right of action in favor of the defrauded investor . . . . "). Furthermore, the Court has used the same "fiduciary duty" analogy in describing the right of action under section 10(b) of the 1934 Act, which Sellers concede applies to privately negotiated transactions. *See Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 11-12 (1971).

Sellers assert that Congress did not intend the 1933 Act to reach "privately negotiated transactions involving sophisticated parties able to fend for themselves." (Pet. Br. 24) In support of this assertion, they rely on Justice Stevens' dissent in *Landreth*, arguing that Congress only wanted to protect investors "who are not in a position to protect themselves from fraud by obtaining appropriate contractual warranties." (Pet. Br. 12, quoting 471 U.S. at 698 (Stevens, J., dissenting)) On the basis of this dissenting view, they ask the Court to conclude that section 12(2) was not intended to provide a remedy for misrepresentations in privately negotiated sales exempt under section 4(2). (*Id.*)

The Court rejected this same argument in *Landreth* and *Gould* when it held that privately negotiated resales of controlling blocks of stock come within the scope of the 1933 Act. 471 U.S. at 692; 471 U.S. at 704. Addressing the remedial purpose of the 1933 and 1934 Acts, the Court stated:

> Reading the securities laws to apply to the sale of stock at issue here comports with Congress' remedial purpose in enacting the legislation to protect investors by "compelling full and fair disclosure relative to the issuance of 'the many types of instruments that in our commercial world fall within the ordinary concept of a security'." *SEC v. W.J. Howey Co.*, 328 U.S. at 299 (quoting H.R. Rep. No. 85, 73d Cong., 1st Sess., 11 (1933)).

Landreth, 471 U.S. at 687. The Court expressly concluded that neither the language nor the legislative history supported the narrower view of the Acts' scope urged by Justice Stevens' dissent.[23] *Id.* at 694-95 n.7.

Sellers' rationale for excluding private transactions from section 12(2) is no more compelling than it was in *Landreth*

[23] This Court addressed a related argument in rejecting an *in pari dilecto* defense to claims under section 12(1) in *Pinter v. Dahl*, 486 U.S. 622 (1988). The court below had expressed the concern that failure to provide such a defense would give too great an advantage to "sophisticated investors." *Id.* at 637 n.13. Rejecting this concern, the Court explained that "[p]ermitting the sophisticated investor to recover also serves to protect the unknowing and innocent investor." *Id.*

and *Gould* as a basis for excluding such transactions from the 1933 Act as a whole. Their argument ignores the difference between the registration requirements and the remedial provisions of the Act. The former focus on getting information to investors who need it; the latter are concerned with the truthfulness of the information provided. Congress was clearly concerned with *both* when it enacted the statute. *See, e.g.*, Maynard, *Section 12(2) of the Securities Act of 1933: A Remedy for Fraudulent Postdistribution Trading?*, 20 Sec. Reg. L.J. 152, 165 (1992) (remedies in sections 11 and 12 were intended to "enforce the dual purpose of the 1933 Act: first, to assure compliance with the disclosure requirements of the Section 5 registration obligations, and second, to eliminate fraud").

It is equally clear, however, that Congress did not view the transactions covered by the two types of provisions as coextensive. *Landreth*, 471 U.S. at 692. This is illustrated by the exemption in section 3(b) of the Act, which authorizes the SEC to add additional classes of securities exempt under section 3 "if it finds that the enforcement of this subchapter with respect to such securities is not necessary in the public interest and for the protection of investors by reason of the small amount involved or the limited character of the public offering." 15 U.S.C. § 77c(b). Any such securities remain subject to an action for rescission under section 12(2), however. *Id.* § 77l(2). Thus, Congress expressly concluded that buyers of securities for whom the protection of the Act's registration requirement is unnecessary should still be protected by the civil remedies of section 12(2).[24]

[24] In support of their argument that section 12(2) applies only to misstatements or omissions in public offerings, Sellers cite the Court's statement in *Randall v. Loftsgaarden* that "Congress chose a rescissory remedy when it enacted § 12(2) in order to deter prospectus fraud and encourage full disclosure." 478 U.S. at 658. This citation is curious, since *Randall* did not involve a public offering of securities. In that case, the Court held that the successful plaintiff in a section 12(2) case was not required to reduce his rescissory award by the amount of tax benefits he received on his investment. *Id.* at 667. The section 12(2) claim in that case arose out of a private placement of limited partnership interests. *See Austin v. Loftsgaarden*, 675 F.2d 168, 173 (8th Cir. 1982).

The reasons for exempting sellers in privately negotiated transactions from the registration requirement do not support excluding such transactions from the antifraud provision of section 12(2). Simply because a purchaser in a private transaction may have the ability to obtain the kind of information that would otherwise be required in a registration statement does not mean that such a purchaser cannot be misled.[25] The courts have long recognized that "sophisticated investors, like all others, are entitled to the truth." *Stier v. Smith*, 473 F.2d 1205, 1207 (5th Cir. 1973). This principle, combined with the lack of any express intent to the contrary, has led the courts to conclude that "[s]ection 12(2) does not establish a graduated scale of duty depending upon the sophistication and access to information of the customer." *Sanders v. John Nuveen & Co.*, 619 F.2d 1222, 1229 (7th Cir. 1980), *cert. denied*, 450 U.S. 1005 (1981).[26]

The distinction between having access to information and having *truthful* information is demonstrated by the facts of this case. Sellers solicited respondents to buy their stock.

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[25] The language of section 12(2) deals directly with the purchaser's ability to obtain information by expressly providing that the purchaser of securities only has a remedy under that section if it did not know of the untruth or omission on which its claim is based. Thus, if the buyer discovers the falsehood, it has no claim; if it does not, there is no reason to deny it a remedy.

[26] The concept of limiting the application of section 12(2) based on the sophistication of the purchaser is both unworkable and inconsistent with the operation of the Act's other remedial provisions. Sophisticated purchasers buy stock in public offerings, and unsophisticated purchasers buy securities in private offerings. For example, the fund manager of a large mutual fund (such as Peter Lynch of Magellan Fund fame) may purchase shares in an initial public offering based on his exhaustive and highly sophisticated analysis of the company's prospects. If the registration statement contains a material misrepresentation, the fund has a cause of action under section 11. If a wealthy investor who knows nothing about the oil and gas business buys a limited partnership in a privately offered oil and gas partnership, there is no sound basis in policy for denying him a remedy for misstatements of fact in the offering documents.

After striking a deal in principle with Sellers, Buyers conducted due diligence. In the course of this due diligence, Buyers raised questions about year-end adjustments to inventory and pressed petitioner McLean for an explanation. McLean, who was Sellers' spokesman on financial issues and in the best position to know, assured Buyers that his methods of estimation were conservative and that any year-end adjustments to inventory would be positive, not negative. Sellers reiterated this assurance by making express representations in the Stock Purchase Agreement – representations made to induce respondents to buy their stock. Only after the closing did Buyers learn that Alloyd's inventory and operating margin had been materially overstated.

Striving for some way to carve their transaction out of section 12(2), Sellers argue that the rescissionary remedy under section 12(2) makes sense only in the context of an initial public distribution "because the seller receives the full purchase price from the buyer and is generally the buyer's sole source of information . . . . " (Pet. Br. 27) But that is precisely what happened in this private transaction. Wind Point purchased the stock of Alloyd from Sellers, and Sellers received the consideration for the stock. While Wind Point conducted due diligence, most of its investigation consisted of discussions with Sellers and review of financial documents prepared by them.[27]

Finally, Sellers and SIA argue that it would have made no sense for Congress to create a broad remedy for all buyers under section 12(2), but not create a similar remedy for sellers. (Pet. Br. 27; SIA Br. 12) There is nothing illogical about this. The entire 1933 Act is directed at those who offer and sell securities. Congress intended to create a remedy for

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[27] Indeed, in *Pinter v. Dahl*, the Court held that rescission under section 12(1) was an appropriate remedy even against a statutory seller who was not the owner of the security and did not receive the consideration paid for it. The Court explained "there is nothing incongruous about forcing a broker or other solicitor to assume ownership of the securities." 486 U.S. at 647 n.23.

buyers so that sellers would be responsible for material misstatements or omissions in touting securities. That Congress did not create a remedy *against* buyers says nothing about which buyers are entitled to the remedy created in section 12(2). Sellers' policy argument that the section 12(2) remedy "should be available to each party" to a negotiated transaction (Pet. Br. 27) is properly addressed to Congress.

III. The Legislative History Does Not Support Petitioners' Narrow Construction Of Section 12(2).

The Court has held that once it finds the terms of a statute to be clear, "judicial inquiry is complete, except in rare and exceptional circumstances." *King v. St. Vincent's Hosp.*, 112 S. Ct. 570, 575 n.14 (1991), quoting *Rubin v. United States*, 449 U.S. 424, 430 (1981). Accordingly, this Court need not address the legislative history arguments advanced by Sellers. (Pet. Br. 32-38) However, should the Court choose to address the legislative history, "[t]he 'strong presumption' that the plain language of the statute expresses congressional intent is rebutted only in 'rare and exceptional circumstances,' when a contrary legislative intent is clearly expressed." *Ardestani v. INS*, 112 S. Ct. 515, 520 (1991).[28]

Neither the legislative history specific to section 12(2) nor that of the Act as a whole compels a narrow reading of section 12(2). *See, e.g.*, Maynard, *The Future of Securities Act Section 12(2)*, 45:3 Ala. L. Rev. (forthcoming 1994) ("The legislative history of the 1933 Act does not undermine the clear import of the statute's language: that the provisions

[28] Reliance on legislative history is particularly inappropriate in interpreting the 1933 Act because the definitions of key terms in the statute, including the definition of "prospectus," are conditioned upon the "context" in which they are used. *See* 15 U.S.C. § 77b ("When used in this subchapter, *unless the context otherwise requires*" . . .) (emphasis added). As explained above, the language and structure of the Act confirm that section 12(2) is not limited to public offerings of securities. Given that, it is inappropriate to look to legislative history to reach a different result. *See Rowland v. California Men's Colony*, 113 S. Ct. 716, 720 (1993).

of section 12(2) apply to those secondary market trading transactions that otherwise satisfy the statute's prerequisites."). The legislative history simply does not establish the "rare and exceptional circumstances" necessary to override the language and structure of the Act.

A. Nothing In The Legislative History Of Section 12(2) Establishes That The Section Is Limited To Public Sales Of Securities.

As this Court has observed, the legislative history of section 12(2) is "sparse." *Randall*, 478 U.S. at 657. Nothing in the House Report (H.R. Rep. No. 85), the Senate Report (S. Rep. No. 875), or the Conference Report (H.R. Conf. Rep. No. 152) on the 1933 Act states that section 12(2) is limited to public offerings. On the contrary, the process of reconciling the House version of section 12(2) with the Senate version evidences that Congress did not make a conscious decision to limit section 12(2) to public sales of securities.

The original Senate proposal of section 12(2) explicitly covered all false or misleading statements used to sell securities:

> Every person acquiring *any security* by reason of any false or deceptive representation made in the course of or *in connection with a sale or offer for sale or distribution of such securities* shall have the right to recover any and all damages suffered by reason of such acquisition of such securities from the person or persons signing, issuing, using, or causing, directly or indirectly, such false or deceptive representation, jointly or severally.

H.R. 5480, 73d Cong., 1st Sess. 25 (1933), as passed by the Senate with Senate amendments, 77 Cong. Rec. 2995, 2998 (May 10, 1933) (emphasis added).

The House version of section 12(2) used different language, language closer to that in the final version of the statute:

> Any person who – (2) sells a security (whether or not exempted by section 3), by the use of any means

> of instruments of transportation or communication in interstate commerce or of the mails, by means of a prospectus or oral communication, which includes an untrue statement of material fact or omits to state a material fact (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such truth or omission, shall be liable to the person purchasing such security from him. . . .

H.R. 5480, 73d Cong., 1st Sess. 25 (1933), as passed by the House on May 5, 1933, 3 Ellenberger & Maher, item 26. If Sellers' interpretation of section 12(2) were correct, the House version would, by its use of the phrase "by means of a prospectus or oral communication," apply to a significantly narrower category of transactions than the Senate version.

After the Conference Committee combined the House and Senate versions of section 12(2), the House managers attached a commentary identifying and explaining the material differences between the two bills, and how they had been reconciled. That commentary stated:

> The Senate amendment imposed liability upon persons making false and deceptive statements *in connection with the distribution or sale of a security.* The House bill made the liability depend upon the making of untrue statements or omissions to state material facts. This phrase has been clarified in the substitute to make the omission relate to the statements made in order that these statements shall not be misleading, rather than making a mere omission (unless the act expressly requires such a fact to be stated) a ground for liability where no circumstances exist to make the omission in itself misleading.
>
> The House bill (sec. 12) imposes civil liability for using the mails or the facilities of interstate commerce to sell securities (including securities exempt, under section 3, from other provisions of the bill) by means of representations which are

> untrue or are misleading by reason of omissions of material facts. The substantially similar provisions of the Senate amendment did not apply to any of the securities exempted under the Senate amendment. . . .

H.R. Conf. Rep. No. 152, 73d Cong., 1st Sess. 26-27 (1933) to accompany H.R. 5480, May 20, 1933 (emphasis added).

If the Committee had intended to narrow the scope of section 12(2) by adopting the House version, one would expect the commentary to discuss this change. It did not. The commentary's silence on the scope of section 12(2) – which would clearly have been a material point of difference – suggests that the Conference Committee saw no substantive difference between the House and Senate versions of section 12(2) on this point. *See Pacific Dunlop*, 993 F.2d at 592. A reasonable inference is that the Committee understood both the House and Senate versions to have the same broad application, and did not intend the final version to apply to a narrower class of transactions than the original Senate version.[29]

At bottom, nothing in the legislative history of section 12(2) or section 2(10) explicitly states that Congress intended to exclude private sales by controlling shareholders from the reach of section 12(2). As the Seventh Circuit observed in *Pacific Dunlop*, the Senate "rarely mentioned the word 'prospectus,' and certainly not in the fraud context of section 12(2)." *Id.* at 590-91 (footnote omitted). In light of this, the Court's observation in *Landreth* about the legislative history of the 1933 and 1934 Acts is equally applicable here:

> The history is simply silent – as it is with respect to other transactions to which these Acts have been applied by the Securities and Exchange Commission

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[29] SIA draws a contrary inference from the Conference Committee's silence – that both the House and Senate assumed that section 12(2) was limited to "the public sale of new issues." (SIA Br. 17-18) As the Seventh Circuit explai. . *Pacific Dunlop*, the broad language of the Senate's version of section 12(2) demonstrates that the Senate intended to prevent fraud in *all* sales of securities. 993 F.2d at 592.

and judicial interpretation over the half century since the legislation was adopted.

471 U.S. at 695 n.7. For fifty years, appellate courts have repeatedly upheld application of section 12(2) to privately negotiated sales of securities. The silence of the legislative history on this particular point is not a sufficient reason to override this precedent.

B. Nothing In The Legislative History Of The Act As A Whole Establishes That Section 12(2) Is Limited To Public Sales Of Securities.

Statements in the legislative history regarding the overarching purpose of the 1933 Act are similarly insufficient to narrow the scope of section 12(2). Relying on general statements of purpose from the hearings, debates and conference reports on the 1933 Act, Sellers argue that Congress must have intended to exclude privately negotiated transactions from the remedial provisions of section 12(2). As this Court has noted, however, "general remarks" that "were obviously not made with [the] narrow issue in mind" are not probative of the meaning of specific words or provisions. *Chevron*, 467 U.S. at 862, quoting *Jewell Ridge Coal Corp. v. United Mine Workers*, 325 U.S. 161, 168-69 (1945); *see also S & E Contractors, Inc. v. United States*, 406 U.S. 1, 13 n.9 (1972).[30]

Equally unconvincing is Sellers' argument that various references to "the public" in the legislative history imply that

[30] These principles are particularly applicable to Sellers' reliance on President Roosevelt's comments recommending passage of the Act. (Pet. Br. 9-10) A president's preliminary comments to Congress provide no basis upon which to interpret specific provisions in the subsequently passed Act. *Cf. Garcia v. United States*, 469 U.S. 70, 77 (1984) (general remarks of Postmaster General recommending passage of a bill did not elucidate meaning of specific statutory term). Likewise, Sellers' references to comments made in 1959 by James Landis add nothing to the analysis. (Pet. Br. 10-11) First, as Mr. Landis admits, "a sense of trepidation must . . . attach to anyone who draws upon recollections, now more than a quarter of a century old, to write the legislative history of the Securities Act of 1933." Landis, *The Legislative History of the Securities Act of 1933*, 28 Geo. Wash. L. Rev. 29, 29 (1959). Second, Mr. Landis never even discusses section 12(2) or the scope of that antifraud provision.

Congress did not intend to protect sophisticated or institutional investors from misrepresentations made to them. (Pet. Br. 38) It is far from clear that, in expressing its broad desire to protect the "investing public," Congress consciously intended to exclude purchasers in private transactions. Mutual funds and venture capital funds (such as respondent Wind Point) are the vehicles through which many members of the "public" invest their capital in both public and private corporations. There is no evidence in the legislative history that Congress even addressed these types of investors, much less intended to exclude them from seeking recompense for material misrepresentations by sellers of securities.

Finally, this Court has never read the legislative history of the Act as limiting its application solely to public offerings. Sellers cite the Court's various statements that the Act was "primarily" intended to address the problems of misleading public offerings. (Pet. Br. 18) None of the cases cited by Sellers, however, holds that the Act is applicable *only* to public offerings.[31] To the contrary, as the Court stated in *Naftalin* in summarizing the exceptionally broad purpose underlying the Act, "neither this Court nor Congress has ever suggested that investor protection was the *sole* purpose of the Securities Act." 441 U.S. at 775.

[31] Petitioners and SIA both rely on the statement in *Naftalin*, that "[u]nlike much of the rest of the act, [section 17(a)] was intended to cover any fraudulent scheme in an offer or sale of securities, whether in the course of an initial distribution or in the course of ordinary market trading." 441 U.S. at 778 (citations omitted). The Court's comment that "*much* of the rest of the act" was intended to apply to new offerings suggests that at least one provision other than section 17 was a similar departure from this intention. Because section 12(2) is "the private analogue of § 17(a)," 9 L. Loss & J. Seligman, *Securities Regulation* 4219 (3d ed. 1992), it is reasonable to infer that section 12(2) is also a "departure" from the narrower focus of the Act.

IV. Considerations Of Policy Do Not Require Limiting Section 12(2) To Public Offerings.

Sellers resort, finally, to a number of policy arguments they contend militate against construing section 12(2) to cover privately negotiated transactions. (Pet. Br. 38-41) As this Court recently stated, policy considerations "cannot override our interpretation of the text and structure of the Act, except to the extent that they may help to show that adherence to the text and structure would lead to a result 'so bizarre' that Congress could not have intended it." *Central Bank of Denver v. First Interstate Bank of Denver*, 114 S. Ct. 1439, 1453-54 (1994), quoting *Demarest v. Manspeaker*, 498 U.S. 184, 191 (1991). None of the policy arguments advanced by Sellers demonstrates that applying section 12(2) to private transactions is beyond the scope of what a rational Congress could possibly have intended.

First, Sellers argue that affording a section 12(2) remedy to purchasers in privately negotiated transactions would "effectively render superfluous Rule 10b-5 and years of precedent with respect to scienter, reliance, and loss causation under that Rule." (Pet. Br. 39) This argument makes no sense. Misrepresentations in *public* offerings, which Sellers concede are covered by sections 11, 12(2), or both, also come within the scope of Rule 10b-5, but Sellers apparently do not regard this far greater overlap as rendering Rule 10b-5 or the precedent interpreting it superfluous. As the Court stated in *Herman & MacLean v. Huddleston*, 459 U.S. 375 (1983), "it is hardly a novel proposition that the Securities Exchange Act and the Securities Act 'prohibit some of the same conduct'." *Id.* at 383, quoting *Naftalin*, 441 U.S. at 778.

Sellers' argument also ignores the differences between section 12(2) and Rule 10b-5 actions. Most importantly, Rule 10b-5 applies to a vastly broader range of transactions than section 12(2). While 12(2) is limited by a strict privity requirement, a plaintiff under Rule 10b-5 may sue anyone who made any false or misleading statement "in connection with" a purchase or sale of securities. *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 12 (1971). The vast majority of Rule 10b-5 cases involve claims by purchasers of stock on the open market who sue corporate issuers, or their officers and directors, with whom they are not in privity – and thus not subject to a section 12(2) claim – for statements that allegedly resulted in a "fraud on the market." Moreover, it would be incongruous to rely on the existence of a remedy created by the courts, not by Congress, as a basis for construing narrowly a remedy expressly created by Congress. *See* 9 L. Loss & J. Seligman, *Securities Regulation* 4220 (3d ed. 1992).

Sellers' second policy argument is that a broad construction of section 12(2) "would have a drastic impact on the thousands of private transactions negotiated and closed yearly" and would "dramatically and unnecessarily increase transaction costs." (Pet. Br. 39) This argument ignores the body of case law already applying section 12(2) to such transactions. For fifty years any sophisticated party represented by competent counsel has known that the courts have applied section 12(2) to privately negotiated transactions. *See, e.g., Adena Exploration, Inc. v. Sylvan*, 860 F.2d 1242, 1244 (5th Cir. 1988) ("Sophisticated purchasers of fractional undivided interests in oil and gas have sought – and obtained – rescission of their purchases pursuant to the 1933 Act for at least thirty years."). Affirming *Pacific Dunlop* would merely maintain the status quo. It is Sellers' narrow reading of the statute that "would upset the justified expectations of both the legal and investment communities." *Reves*, 494 U.S. at 75 (Stevens, J., concurring).

Nor can a narrow reading of the statute be justified by the desire to reduce transaction costs. Contrary to Sellers' argument, applying section 12(2) to private sales of securities would not require sellers "to disclose all the information required in a registration statement." (Pet. Br. 39-40) Section 12(2) imposes liability only if the seller makes a material misstatement of fact or omits a fact necessary to make the

affirmative statements not misleading.[32] 15 U.S.C. § 77l(2). There is nothing inefficient or anti-business about requiring a party with superior information to tell the truth. Nor is it irrational or "bizarre" for Congress to impose liability on a seller who negligently makes a misstatement or omission of material fact to a party with whom he has negotiated to sell his business.

Third, Sellers argue that a broad construction of section 12(2) would improperly make federal cases out of state-law breach of contract cases. (Pet. Br. 41) The same argument could be made that the section 12(2) remedy federalizes state tort claims for negligent misrepresentation in connection with sales of securities. Both arguments are expressly addressed in section 16 of the Act, which provides: "The rights and remedies provided by this subchapter shall be in addition to *any and all other rights and remedies* that may exist at law or in equity." 15 U.S.C. § 77p (emphasis added). Indeed "an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections." *Herman & MacLean*, 459 U.S. at 388-89. Moreover, substantially fewer cases would support a section 12(2) claim than a claim for breach of contract since the former imposes liability only on a seller who is negligent while the latter requires no finding of fault, only a breach.

Finally, Sellers assert that availability of section 12(2) to purchasers in privately negotiated deals would "provide an irresistible temptation" for any disappointed buyer "to concoct a claimed misrepresentation." (Pet. Br. 41) This argument barely merits a response. There is no reason to believe that sophisticated businesspersons, represented by competent counsel, are more susceptible to this "irresistible temptation" than purchasers of shares in public offerings. If the potential

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[32] Indeed, the language of section 12(2) was changed in conference to make clear that a seller could not be held liable for all omissions, which would effectively have imposed a broad duty of disclosure under section 12(2), but only for those omissions that would make an affirmative statement by the seller misleading. H.R. Conf. Rep. No. 152, 73 Cong., 1st Sess. 26 (1933) to accompany H.R. 5480, May 20, 1933.

for frivolous lawsuits were a basis for construing statutes to deny remedies, this Court would have abolished the Rule 10b-5 cause of action years ago.

V. The Alternative Construction Proposed By *Amicus* SIA Does Not Support Reversal Of The Judgment Below.

The brief filed by *amicus* SIA focuses on an issue not presented by the facts of this case: whether section 12(2) creates a remedy against brokers and others who provide investors with research reports on corporations. (SIA Br. 1) The Court can decide the narrow question presented by this case – whether section 12(2) applies to a sale of stock by controlling stockholders in a privately negotiated transaction – without reaching this broader question. The questions raised by SIA regarding liability of brokers for research reports on publicly traded securities, availability of rescission for misrepresentations by defendants who do not receive the purchase price, and other issues regarding the outer reaches of section 12(2) are not before the Court and need not be resolved in this case.[33]

In support of its position that section 12(2) should not reach misstatements by brokers and others who are not the owners of the securities being sold, SIA proposes a construction of section 12(2) different from that urged by Sellers. SIA argues that section 12(2) applies only to initial distributions of securities, which it defines as "initial public offerings" and "subsequent public offerings by an issuer." (SIA Br. 2 & n.2) In other words, SIA asserts, section 12(2) applies only to the "public distribution of newly issued securities." (*Id.* at 4) This construction has no more basis in the text and structure of the Act than Sellers'.

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[33] This Court has repeatedly declined to address questions not raised by the petitioner and argued for the first time in the brief on an *amicus curiae*. *See, e.g., Kamen v. Kemper Fin. Services, Inc.*, 500 U.S. 90, 97 n.4 (1991); *United Parcel Service, Inc. v. Mitchell*, 451 U.S. 56, 60 n.2 (1981).

A. SIA's Alternative Reading Of Section 12(2) Is Not Supported By The Text, Structure, Or Legislative History Of The Act.

SIA's argument that section 12(2) is limited to "initial distributions of securities" suffers from the same threshold infirmity as Sellers' argument: the text and structure of the statute do not expressly provide such a limitation. This Court should reject SIA's invitation to make up a limitation that Congress did not enact.

Section 12(2) on its face refutes SIA's argument that it applies only to "initial public offerings and subsequent public offerings *by an issuer*." (SIA Br. 2 n.2, emphasis added) The section explicitly applies to "[a]ny person" who offers or sells a security; it is not limited to "issuers" who offer or sell. Moreover, section 2(10) defines "sale" and "sell" to include "*every* contract of sale or disposition of a security" and defines "offer" to include "*every* attempt or offer to dispose of, or solicitation of an offer to buy, a security." 15 U.S.C. § 77b(3) (emphasis added). The other sections of the Act, such as section 11, demonstrate that when Congress intended a particular provision to apply to "issuers" or other specific categories of persons, it made this explicit. That it did not do so in section 12(2) is dispositive of this point.

Like the argument of Sellers, SIA's textual argument relies primarily on the use of the phrase "by means of a prospectus or oral communication."[34] (SIA Br. 4-9) SIA's argument that "prospectus or oral communication" should be read as limited to initial offerings by issuers is no more persuasive than Sellers' public/private limitation. The terms used in defining "prospectus" cannot be read as limiting section 12(2) to misleading statements made only in initial offerings of stock. Had Congress intended to limit section 12(2) to this specific category of securities transactions, it would have done so explicitly, not indirectly.

[34] SIA also argues that "prospectus" limits section 12(2) to "public" offerings. (SIA Br. at 7-9) That argument is addressed in section I, C above, and will not be repeated here.

Equally unconvincing is SIA's structural argument that section 12(2) must be construed narrowly because sections 11 and 12(1) provide civil remedies only for "violations that arise in the course of initial offerings." (SIA Br. 9-10) Section 11 by its terms clearly applies to a registered secondary offering of existing shares, whether sold by the issuer or by a stockholder. 15 U.S.C. § 77k(a). Similarly, section 12(1) applies to a public secondary sale of unregistered shares by a stockholder deemed to be an underwriter under the Act and thus not entitled to exemption under section 4. *See id.* § 77d(1); 7B J. Hicks, *Exempted Transactions Under the Securities Act of 1933* § 9.03[1], at 9-180 to 9-182 (1st ed. 1994). In short, SIA is incorrect in asserting that the provisions of sections 11 and 12(1) – and thus 12(2) – are limited to "the universe of possibilities in an initial distribution." (SIA Br. 9-10)

Nor is there any basis in the structure of the Act or the definition of "prospectus" for limiting section 12(2) to "newly issued securities." If a large shareholder of a corporation decides to make a registered public secondary offering of the corporation's stock, that offering may be of existing shares or newly issued shares. Whether the shares are existing or newly issued, misrepresentations in the registration statement would be subject to section 11's remedies. Under SIA's reading, however, there would be section 12(2) liability for misstatements in the prospectus only in one case.

The agencies responsible for enforcing the Act have long held the view that section 12(2) is not limited to newly issued securities or initial offerings. Shortly after the Act was signed into law, the Federal Trade Commission, the agency initially responsible for administering the Act, issued a release explaining the effective dates of the various provisions of the Act. The release stated that both sections 12(2) and 17(a) "apply to outstanding securities as well as to new issues which are to be placed in the market after registration." *Effective Dates of Securities Act of 1933 Are Explained*, 1933 SEC LEXIS 8, at 2 (June 2, 1933).

The SEC has similarly stated that section 12(2) is not limited to initial distributions of stock. In a 1941 report to the

House of Representatives, the SEC stated: "Section 12(2) of the act permits a purchaser to recover from a person who has sold securities to him on the basis of untrue statements or misleading omissions. It does not distinguish between sellers engaged in a distribution subject to registration and those selling outstanding securities." House Comm. on Interstate and Foreign Commerce, *Report of the Securities and Exchange Commission on the Proposals for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934*, 77th Cong., 1st Sess. 14 (Comm. Print 1941). As discussed above, these early interpretations by the agencies responsible for enforcing the Act are entitled to substantial weight.

The legislative history arguments advanced by SIA (SIA Br. 13-18) are generally duplicative of those advanced by Sellers. For the reasons explained above, there is no definitive legislative history demonstrating that Congress intended to limit section 12(2) to initial distributions of securities. SIA's additional arguments should be rejected for three reasons.

First, the individuals principally involved in drafting the Act expressed the contemporaneous view that section 12(2) applies to aftermarket transactions. For example, Arthur Dean, who consulted with the House Commerce Committee during the drafting process, and then-professor Felix Frankfurter, the head of the team that drafted the Act, both wrote that section 12(2) applies to secondary transactions as well as initial distributions.[35] That view was echoed even by early critics of the Act. For example, an American Bar Association committee seeking an amendment to the civil liability provisions noted that section 12(2) "is not confined to those sellers who have special sources of information but applies to all sellers of securities." *Report of the Special Comm. on Amendments to the Securities Act of 1933*, 59 Rep. A.B.A. 565, 578

[35] *See* Dean, *The Federal Securities Act: I*, 8 Fortune 50, 102 (1933) (section 12(2) applies to "anyone selling any security including outstanding securities . . . or securities exempt from registration . . . "); Frankfurter, *The Federal Securities Act: II*, 8 Fortune 53, 108 (1933) (the Act applies to "the sale of all private or foreign government securities, new or old.").

(1934). With a few recent exceptions, commentators have also consistently said that section 12(2) is not limited to initial offerings.[36]

Second, SIA acknowledges that "the scope of the 1933 Act is not limited exclusively to initial offerings," but then argues for a narrow construction of section 12(2) because nothing in the legislative history indicates Congress intended to broaden the scope of section 12(2) beyond initial distributions. (SIA Br. 14) That argument turns the issue on its head. Given that the Act as a whole is not limited to initial offerings and section 12(2) does not contain such an express limitation, there is no reason to demand legislative history justifying application of section 12(2) to secondary offerings.

Third, SIA cites to numerous comments by individual Members reflecting their views on the supposed purpose of the Act. (*See, e.g.*, SIA Br. 15-17) However, this Court has repeatedly "eschewed reliance on the passing comments of one Member, and casual statements from the floor debates." *Garcia v. United States*, 469 U.S. 70, 76 (1984) (citations omitted); *see also Chrysler Corp. v. Brown*, 441 U.S. 281, 311

[36] *See, e.g.*, L. Loss, *Securities Regulation* 996-97, 1006-08 (1951); 3 L. Loss, *Securities Regulation* 1699, 1712 n.89 (2d ed. 1961); 9 L. Loss & J. Seligman, *Securities Regulation* 4217-4222 (3d ed. 1992); 3A H. Bloomenthal, *Securities and Federal Corporate Law* § 8.05[3], at 8-43 to 8-44.8 (1993); 2 A. Bromberg & L. Lowenfels, *Securities Fraud & Commodities Fraud* § 5.2, at 600 (1993); 1 T. Hazen, *The Law of Securities Regulation* § 7.5, at 318 (2d ed. 1990); 17A J. Hicks, *Civil Liabilities: Enforcement and Litigation Under the 1933 Act* § 6.01[3], at 6-12 to 6-30 (1993). Several recent articles reach the same conclusion. *See, e.g.*, Maynard, *Section 12(2) of the Securities Act of 1933: A Remedy for Fraudulent Postdistribution Trading?*, 20 Sec. Reg. L.J. 152 (1992); Rapp, *The Proper Role of Securities Act Section 12(2) as an Aftermarket Remedy for Disclosure Violations*, 47 Bus. Law. 711 (1992). Recently, contrary views have been expressed in Weiss, *The Courts Have It Right: Securities Act Section 12(2) Applies Only to Public Offerings*, 48 Bus. Law. 1 (1992), and Prentice, *Section 12(2): A Remedy for Wrongs in the Secondary Market?*, 55 Alb. L. Rev. 97 (1991).

(1979) ("[t]he remarks of a single legislator, even the sponsor, are not controlling in analyzing legislative history").

In sum, the statutory text and structure support the Seventh Circuit's reading of section 12(2), and the legislative history does not provide the kind of unambiguous evidence necessary to dictate a contrary construction. Construing section 12(1) of the Act in *Pinter*, this Court held that "[w]e must assume that Congress meant what it said." 486 U.S. at 653. The Court should similarly reject SIA's attempt to read into section 12(2) a limitation that Congress did not put there.

B. SIA's Proposed Construction Is Inconsistent With The Remedial Purpose Of The Act And Not Required By Any Compelling Policy Concerns.

Construing section 12(2) as limited to sales of newly issued stock by issuers would exempt from the civil remedies of the Act numerous securities transactions for which the negligence-based remedy is particularly appropriate. For example, there is no sound policy rationale for excluding from section 12(2) substantial secondary offerings by shareholders of either public or private corporations. The interests of the purchaser in having truthful information about the securities is the same in either case.

SIA's policy argument that potential section 12(2) liability will chill the dissemination of analysts' reports is unfounded and goes well beyond the issue presented by the facts of this case. This argument is apparently based on SIA's misreading of *Pacific Dunlop* as holding that section 12(2) applies to any material misstatements or omissions made "in connection with" the sale of a security. As discussed above, the holding of *Pacific Dunlop* is not so broad. The Seventh Circuit in *Pacific Dunlop* held that section 12(2) applies to misrepresentations in written or oral communications that offer securities for sale or confirm the sale of a security. Thus, the court did not construe the civil remedy as extending beyond those statements, either written or oral, made during the actual selling process.

It is far from obvious that an analyst's report summarizing the current business and future prospects of a company constitutes a communication that offers a security for sale or confirms the sale of a security.[37] In any event, this issue was neither raised by the parties nor addressed by the courts below, has not adequately been developed by other lower courts, and thus need not be decided in this case. Similarly, if analysts' reports may in some circumstances come within the definitions of "prospectus," it is not clear how high the threshold is for a brokerage firm to establish that it was not negligent. Again, this is an issue that requires development in the lower courts and need not be resolved in order to decide this case.

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[37] The extent of brokers' liability for their research reports under section 12(2) raises the issue left open by the Court in *Pinter*, 486 U.S. at 642 n.20. In *Pinter*, the Court held that a nonowner of securities who solicits another to purchase, motivated by a desire to serve his own financial interests or those of the owner of the securities, is a statutory "seller" under section 12(1). The Court did not decide whether the same analysis applied to section 12(2), and need not address this issue here because Sellers were the owners of the stock and passed title to Buyers.

CONCLUSION

For the reasons stated above, the judgment of the court of appeals should be affirmed.

Respectfully submitted,

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